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# bulletin

# for international fiscal documentation

## Bulletin de Documentation Fiscale Internationale

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Bureau International de Documentation Fiscale
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# BULLETIN FOR INTERNATIONAL FISCAL DOCUMENTATION

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## PURPOSE

The International Bureau of Fiscal Documentation was founded in 1938. For reasons of organizing character this Bureau is established as a separate foundation according to Netherlands law. The Bureau is a scientific, independent, non-profit making, non-political foundation of which the purpose is defined in the articles as follows:

*(Art. 2)* The Foundation, International Bureau of Fiscal Documentation, established as a foundation of the International Fiscal Association (hereinafter referred to as I.F.A.) shall strive towards a fruitful cooperation with the I.F.A.

The objectives of the Foundation are to set up and maintain an international documentation bureau for the purpose of disseminating information concerning tax legislation and the application of taxation law, as well as for furthering the pursuit of knowledge about taxation.

## L'OBJET DU BUREAU

Le Bureau International de Documentation Fiscale fut fondé en 1938. Pour des raisons d'organisation, ce Bureau est établi comme une fondation séparée conformément au droit civil néerlandais. Le Bureau est une institution scientifique, indépendante, sans but lucratif et sans objet politique, dont le but est défini dans les statuts comme suit:

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Les objectifs de la Fondation sont d'établir et assurer le fonctionnement d'un bureau de documentation international dans le but de diffuser des informations concernant la législation fiscale et l'application des lois fiscales, et de faire progresser la recherche en matière d'imposition.

(*Art. 3*) The Foundation shall endeavour to achieve these objectives:

a. by setting up a library of tax legislation, together with relevant books, journals and other publications;
b. by supplying detailed and general information;
c. by allowing the inspection of works acquired by the library, with the permission of the director and subject to the conditions imposed by him (which may also be of a financial nature);
d. by producing publications;
e. by cooperating with the publications of others;
f. by all other lawful means.

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The Bureau also publishes *European Taxation*, a monthly journal on the tax systems of Europe. *Tax News Service*, published twice per month, provides rapid information on world-wide tax developments. *Supplementary Service to European Taxation* is a loose-leaf reference work.

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The loose-leaf series, *Tax Treaty Guides* comprises "Handbook on the U.S.—German Tax Convention" and "Handbook on the Dutch—German Tax Convention" (in German). The Bureau has also published four loose-leaf reference works, *Corporate Taxation in Latin America, African Tax Systems, Taxes and Investment in the Middle East* and *Taxes and Investment in Asia and the Pacific.*

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Le Bureau publie aussi *European Taxation*, revue mensuelle sur les systèmes fiscaux européens. *Tax News Service*, publié deux fois par mois, donne une information rapide, à l'échelle mondiale, de tout ce qui touche à la fiscalité. *Supplementary Service to European Taxation* est un ouvrage de référence présentée sous feuilles mobiles.
*Guides to European Taxation*, également une publication sous feuilles mobiles, comprend "L'imposition de Redevances, Dividendes et Intérêts en Europe", "L'imposition des Sociétés de capitaux en Europe", "L'imposition de revenu des investissements privés" et "La Taxe sur la Valeur Ajoutée en Europe".

*Tax Treaty Guides*, une autre publication sous feuilles mobiles, comprend le "Manuel relatif à la Convention fiscale Allemagne — Etats Unis" et le "Manuel relatif à la Convention fiscale Pays-Bas —Allemagne" (en langue allemande). Le Bureau a également publié, *Corporate Taxation in Latin America, African Tax Systems, Taxes and Investment in the Middle East* et *Taxes and Investment in Asia and the Pacific*, ouvrages d'information sous feuilles mobiles.

## I.F.A. — INTERNATIONAL FISCAL ASSOCIATION

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*Aim — Article 2*
The aim of the Association is the study and advancement of international and comparative law in regard to public finance and especially international and comparative fiscal law and the financial and economic aspects of taxation.

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The Association shall endeavour by all legal means to realise this aim: a) by scientific research; b) by holding congresses and conferences; c) by publications; d) by cooperation with all data collecting organisations, especially the International Bureau of Fiscal Documentation in Amterdam; e) by all other appropriate methods.

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of the January 1980 issue

*tax. The proposed text of the new VAT legislation and the explanation thereto have been reproduced in this issue.*

ETATS UNIS: LA TVA DEVANT LE CONGRES

Le 22 octobre 1979 M. Ullman, Président du Comité "Ways and Means" introduit la "Tax Restructuring Act 1979", prévoyant une réduction massive des impôts sur le revenu et de sécurité sociale. Cette réduction sera compensée par l'introduction simultanée d'une taxe sur la valeur ajoutée de type européen. Le texte proposé de la nouvelle législation sur la TVA et les explications s'y rapportant sont réproduits dans ce numéro.

U.S.A.: DIE MEHRWERTSTEUER IM KONGRESS

Am 22. Oktober 1979 hat Herr Ullman, der Vorsitzende des "Ways and Means" - Ausschusses, das Steueränderungsgesetz 1979 (Tax Restructuring Act of 1979) eingebracht, das, würde es angenommen, zu einer erheblichen Ermässigung bei der Einkommensteuer und bei den Sozialversicherungsbeiträgen führte.

Die Steuerausfälle würden durch die gleichzeitige Einführung einer Mehrwertsteuer nach europäischem Vorbild aufgefangen. Der Text des Gesetzesverschlages sowie die entsprechenden Erläuterungen sind in dieser Ausgabe abgedruckt.



## Next issue:

**The next Bulletin will be a double issue (February/March 1980) which will, inter alia, contain:**

**The proceedings of the technical session of the U.S.A. branch of IFA of March 15, 1979. Various subjects with respect to treaties concluded by the United States are discussed**

**Indonesia: Tax incentive package to support the third five-year development plan — by *Jap Kim Siong***

**An epilogue to a decade of Federal Government budgeting in Nigeria — An appraisal of the 1979/80 Nigerian Federal Government Budget — by *F. Akin Olaloku***

**Malaysia: Budget 1980**

**Council of Europe: Colloquy on tax evasion in March 1980**

# A Short Review of the Ethiopian Income Tax System

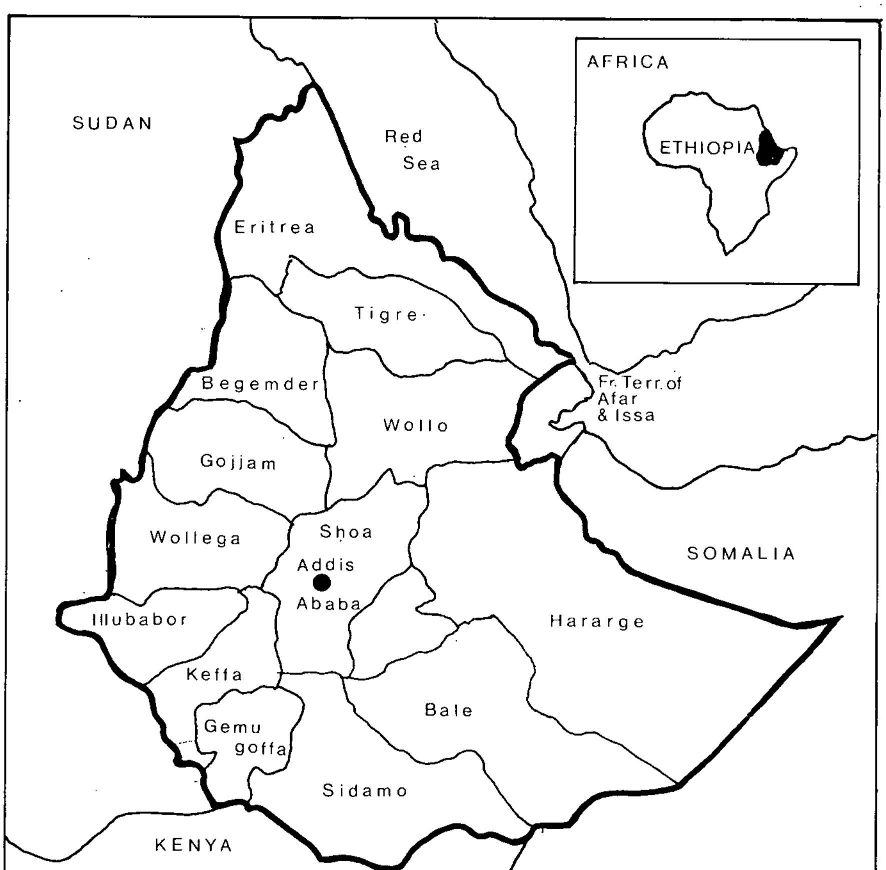
by M. Fisseha-Tsion *

## INTRODUCTION

*Ethiopia is currently undergoing tremendous changes in the very fabric of its existence. Political, economic and legal changes have taken place at such a swift pace that a major transformation has occurred in daily life. Numerous laws have been enacted legitimizing the restructuring of the socio-economical and political organizations which administer the new reforms. A metamorphosis too has taken place in the fiscal laws resulting in the entire restructuring of the tax system bringing about confusion and incomprehension.*

*Readers therefore interested in the Ethiopian legal system in general and the economic and fiscal laws in particular are advised to update their information in this area. However, as a practical matter this process might prove to be difficult as information on the new developments is hard if not impossible to obtain.*

*Because of this situation the author would like to emphasize that any errors in information contained in this article are due to the rapidly changing situation in Ethiopia. However, he will take sole responsibility for any inaccuracy contained herein.*

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* **LL.B, LL.M, formerly taxation adviser in the Ministry of Finance of Ethiopia. A recipient of a scholarship from the International Bureau of Fiscal Documentation, he is currently writing his doctoral dissertation on *The taxation aspects of payments arising from the transfer of technology to developing countries* at the University of Amsterdam.**

# I. A BIRD'S EYE VIEW OF SOME OF THE SOCIO-ECONOMIC CONDITIONS OF ETHIOPIA

## A. Climatic conditions

Ethiopia has an ideal climate. It is partly temperate and partly tropical. Because of its altitude, the humidity is low and the average annual temperature is 13°C (55°F) except in certain places along the Rift valley areas.

It has abundant rainfall and large under-utilized rivers. In short, due to its size and variety of climatic conditions it is capable of growing all types of temperate and tropical agricultural products [1] and yet the country has not been able to feed itself. Its people still suffer from hunger, malnutrition and the lack of the basic necessities of life.

## B. Government

### 1. Current situation

The country is now run by a Military Government which calls itself "Provisional" and the state a "Socialist State". It is officially called "The Provisional Military Government of Socialist Ethiopia". The Provisional Military Administrative Council (PMAC) is the executive as well as the legislative body of the State. Despite this appellation, there has been little or no political socialization of the State. The Military as an organized institution has assumed for itself the role of a democratic regime in absence of any other viable civilian alternative.

### 2. Political parties, organizations and national fronts

There are over a dozen political organizations and fronts organized legally and illegally under vaguely defined objectives and causes. They include right wing elements who aspire to restore the old order and national fronts seeking secession and full sovereign independence from Addis Ababa Government. There are also self-styled Marxist-Leninist organizations which in theory recognize, inter alia, the right of nations to self-determination but who nonetheless do not have the political will and desire to translate their slogans into deeds. However, there is no broadly based communist or socialist or capitalist oriented party at the regional and national levels which can command the respect and confidence of the overwhelming majority of the population. The on-going civil war between and among the bulk of the population is instigated by such political organizations and fronts. Whether the bulk of the population has a clear idea of why they are fighting among and between themselves is a perplexing question raised by all concerned about the anti-developmental perpetual state of war.

## C. Components of the economy

Despite its agricultural, mineral, and oil potential and its capability of producing exportable livestock, Ethiopia is categorized as one of the world's half-dozen poorest and most backward countries which during Haile Selassie's reign was ravaged by famine, disease and malnutrition. Even today starvation and poverty are still prevalent. Ethiopia has a predominantly agricultural and pastoral economy that exists on a subsistence level.

### 1. Rural economy

The rural economy consists basically of small individual farms whose farmers account for 95 percent of the total agricultural production of the country but who have little or no say in the marketing of their produce. Although 80 to 90 percent of Ethiopia's exports consists of agricultural goods, because the state owned farms are more mechanized they produce most of the cash crops for exports. Coffee accounts for a substantial 70 percent of Ethiopia's export bill.

Land ownership is primarily vested in the government. At present all privately owned rural holdings of more than 20 hectares and urban lands and buildings in addition to most major industries, banks, insurance companies and other financial institutions have been nationalized.

Land is usually held by families (in a broad sense), village communities, private persons and the Government. Ethiopia had one of the most intricate land tenure systems in the world; however, after 1974 land was declared to be the "property of the whole people", and not to be used for speculation and profit.

The farming population is being organized into "Peasant Associations" [2] in order to increase production and improve farming methods. There are more than 27,000 peasant associations with about 8 million members, 500,000 of whom have joined peasants' defence squads. [3]

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1. Some of the crops grown include coffee, wheat, barley, maize, oats, millet sorghum, sugar cane, potatoes as well as other roots and tubers, beans, peas, broad beans, chick peas, lentils and other pulses, ground nuts, castor beans, rapeseed, linseed, sesame seed, cotton seed, cotton (lint), sunflower seed, vegetables and fruits of various kinds and descriptions.
2. "Peasant Associations" are legal associations composed of individuals who at the time of the Rural Lands Proclamation of March 4, 1975 and thereafter were tenants, landless persons, agricultural labourers or landowners with less than ten hectares of land. Such associations are empowered to establish judicial tribunals to hear land disputes arising within each locality and control travelling of persons from one locality to another.
Organizations of the peasantry (constituting no less than 85 percent of the population) include:
(a) Peasant Associations at local levels;
(b) All Ethiopian Peasant Associations at the national level.
Sources: — Public ownership of Rural Lands Proclamation No. 31, 1975.
— Peasant Associations Organization and Consolidation Proclamation No. 71, 1975.
— All Ethiopia Peasant Association Proclamation No. 130, 1977.
3. "Peasants' defence squads" are sub-divisions of peasant associations designed to recruit militiamen and women to form the People's Militia to safeguard and protect the programme of the Government and to defend the country's territorial integrity.

Moreover, Revolutionary Administrative and Development Committees [4] have also been set up.

### 2. Urban economy

Urban areas are centers of Ethiopia's industrial, commercial, diplomatic, administrative and business communities. One third of all the health facilities are located in Addis Ababa, Asmara and Harar. The entire urban population has been organized, irrespective of their profession but based on the locality in which they live, into Urban Dwellers Associations. [5] These associations (almost 1200) have substantial control and power within their respective neighborhoods, [6] with a membership of about 3 million.

## D. Industry

The principal industrial activities in Ethiopia include the manufacturing and processing of tinned meat, vegetable oils, wheat flour, macaroni, refined sugar, liqueurs, wine, beer, lemonade, mineral waters, cigarettes, cotton yarn, woven cotton fabrics, woollen blankets, woollen carpets, nylon fabrics, leather footwear, canvas and rubber footwear, plastic footwear, plywood, particle board, soap, ethyl alcohol, refining of some petroleum products, clay building bricks, quicklime, cement, nails.

## E. Mining

There is substantial evidence to suggest that Ethiopia may have oil and gas around the Dahlak islands in the area 75 miles north of Massawa and the southern part of the Red Sea as well as in the south eastern part of the country. There are also vast potential resources of geothermal power along the Rift valley.

Other considerable mineral deposits include agate, asbestos, bentontic clay, barite, copper, diatomite, feldspar, gold, gypsum, iron, kaolin, lignite, limestone, magesium, marble, mica, nickel, platinum, potash, pumice, salt, silica, sulphur, talc and zinc. [7]

To date Tenneco, General American Oil company and Shell have concessions to exploit the oil and gas, [8] with the terms of the concessions granted during the Haile Selassie Government still in force.

## F. Labour

The number of industrial workers is approximately 500,000. The minimum salary for unskilled persons is 2 birr per day. Labour legislation was enacted which claimed to advance the interests of the Ethiopian workers and to improve the working conditions over the pre-1974 period. [9]

## G. Imports

The main imported products include mineral fuels, lubricants, etc., including crude petroleum and petroleum products, chemicals, medical and pharmaceutical products, manufactured rubber products including tyres and tubes, textile yarn and thread, textile fibres, iron and steel, machinery in general including agricultural machinery and implements, textile and leather machinery, electrical machinery applicances, telecommunications apparatus and transport equipment including motor vehicles and parts, aircraft and clothing.

## H. Exports

Exported products include food and live animals, meat and meat preparations, fruit and vegetables, coffee (green or roasted), hides and skins (undressed), oilseeds, oil nuts and oil kernels, sesame seeds.

## I. Foreign investment

The nationalization of financial institutions, insurance companies, large industries, rural and urban private land and buildings and schools on one hand and the formation of peasant and urban dwellers' associations to control rural and urban activities as well as the encouragement of the formation of cooperatives and industrial workers' councils, inter alia, imply that in post-1974 Ethiopia, there is little room for companies to do business in real estate. This means that a foreign company is not allowed to engage in the trading of land and buildings, except as an integral part of its factory. Foreign companies are, however, entitled to have a right of possession in the land for which they have to pay a rent or use fee as the case may be. It is therefore not possible to acquire land for resale or trade.

Large scale development of land either for agriculture, dairy or forestry or otherwise is mainly carried out at the initiative of the State through its own specialized bodies and State economic organizations. Foreign com-

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4. "Revolutionary Administrative and Development Committees" are committees set up to consolidate and implement the National Democratic Revolution Programme issued by the Government.
5. "Co-operative Societies of Urban Dwellers" are neighbourhood societies having juridical personality of which any urban (i.e. within the boundaries of the municipality or a town) dweller may become a member subject to restrictions provided by law (see Government Ownership of Urban Lands and Extra Houses Proclamation No. 47/1975).
6. Organizations of neighbourhoods include:
(a) Co-operative societies of urban dwellers in each unit of urban areas.
(b) Higher co-operative societies of urban dwellers at intermediate level.
(c) Central co-operative societies of urban dwellers at the highest level depending on the size and population of the urban area.
Source: Government Ownership of Urban Lands and extra houses Proclamation No. 47, 1975)
7. See M. Fisseha-Tsion, *A survey of the taxation of mineral and oil resources; with particular reference to Ethiopia*, LL.M. thesis, the Faculty of Law, University of Leeds, U.K. (unpublished), August 1976.
8. Id., pp. 31-41.
9. *Organizations of labour* working in ex-privately owned as well as State-owned enterprises:
(a) Individual Trade Unions at enterprise level.
(b) All Ethiopia Trade Unions at the centralized and national levels.
Source: Labour Proclamation No. 64, 1975.

panies have little or no opportunity to own land but may be allowed to get long term leases from the State to perform some of the approved activities.

Foreign investors do not have the freedom to invest in all activities. The areas in which foreign investors are allowed to do business are provided in the Government's economic policy declaration and in the Government ownership and control of the Means of Production Proclamation No. 26 of 1975. [10]

In order to systematically organize and implement the economic and development policy of the Government, a Central Planning Supreme Council has been established by virtue of Proclamation No. 156/1978. This implies that individual private industrial enterprises, privately owned banks etc., have little scope to invest in any activity they think fit. The Haile Selassie Government's policy of "you are welcome to invest in what you like" has been replaced by a policy of "you are welcome to invest in accordance with our national plan".

### 1. Activities where foreign collaboration is needed

Areas in which there is co-operation with foreign investors include the following:

a) *Financing* of Government approved industrial and agricultural projects.
b) *Technological assistance* and foreign technical and managerial collaboration with or without foreign loans or credits to finance the capital expenditures and in some cases ordinary expenditures of such projects.
c) *Direct foreign investment* enabling the foreign investor to own 49 percent of the equity interest in Ethiopia's industrial enterprises.
d) *Joint ventures* in Government approved activities.

### 2. Exchange transactions

All transactions in foreign exchange must be carried out through an authorized bank under the control of the National Bank. [11]
Foreign investors are permitted to transfer their earnings abroad subject to the approval by the Government.
Foreign employees of the private sector may remit a maximum ranging between 40 and 50 percent of their net earnings during the period of service and upon final departure. Other expatriate employees may on final departure take out the same maximum amount but not more than 20,000 birr in any one year. [12]

## J. Tax structure

The existing fiscal structure of Ethiopia is schedular, primarily designed to raise revenue for the Government, although there is no substantial proof that the fiscal system has achieved the objective for which it was intended. The low yield of revenue of the fiscal system is evidenced by the figures indicated below.

**Total Revenue Yield (million birr)**

| Year | 1973/74 | 1974/75 | 1975/76 | 1976/77 | 1977/78 |
|---|---|---|---|---|---|
| Total revenue | 754.4 | 804.7 | 615.5 | 659.0 | 932.9 |

*Source:* Ministry of Finance (unpublished notes)

However, the external loans for accounting year 1978-1979 are as follows:

| *Donor* | *Activity/project* | *Amount* |
|---|---|---|
| IDA (International Development Agency) | Agricultural development projects | 52,973,000 |
| IDA | Washed coffee project | 2,569,600 |
| IDA, PRC (People's Republic of China), UK | Water supply | 4,129,800 |
| IDA, PRC, EEC, FRG (Federal Republic of Germany), UK, ADA | Road construction | 105,172,400 |
| IDA | Fifth Telecommunication programme | 20,000,000 |
| IDA | General education and other community services | 27,897,300 |
| IDA | Higher education | 5,260,000 |
| USSR | Mining | 513,400 |
| ADB, PRC, FRG | Electricity supply | 22,148,700 |
| GDR (German Democratic Republic) | Port expansion | 4,000,000 |
| | | 244,664,500 |

*Source:* Provisional Military Government of Socialist Ethiopia; Budget for the Fiscal Year 1971 (1 Hanle 1970-30 Sene 1971) (1978-79).
Negarit Gazeta – No. 1, 7th October 1978, pp. 9-10.

## II. THE TAXATION OF INCOME

### A. Introduction

Income tax is imposed on taxable income, i.e. on gross income less allowable deductions. However, what is considered to be "income" itself is not clear. It is defined as "every sort of revenue from whatever source . . . which has its origin within Ethiopia". [13] There is no distinction made between "income" and "capital". To be subject to income tax the *origin* of the taxable income must be *within* Ethiopia, i.e. income originating outside Ethiopia is not subject to tax under Ethiopian law.

10. Note that the following foreign investment laws are also still in force:
— Notice No. 10 of 1950;
— Investment Decree 1963 which has been renumbered Investment Proclamation No. 242 of 1966.
11. For detailed information see, *Annual Report Exchange Arrangements and Exchange Restrictions 1979 International Monetary Fund*, pp. 150-152.
12. Id., p. 150.
13. Income Tax Proclamation 1961, Art. 4 cum Art. 3(3).

## 1. Pre-1974 income tax structure

Before the political changes of September 12, 1974 there were four schedules under which income tax was payable:

- *Schedule A.* Employment income; income tax at progressive rates is due within the month following the period of payment of the income; [14]
- *Schedule B.* Income from rent of land and buildings (irrespective of the purposes for which the land and buildings were to be used), including income from crop-sharing arrangements made between owners of the lands and tenants. The tax is paid annually on a *preceding year basis*; [15]
- *Schedule C.* Income from any trade, business, profession or vocation [16] and from:
  - (i) the exploitation of woods and forests for lumbering purposes; [17]
  - (ii) the processing or transforming of agricultural products; [18]
  - (iii) other activities relating to agriculture, forestry, breeding cattle or maintaining pasture land, provided the said activities are considered as being pursued by traders or by business organizations of a commercial nature according to the commercial code of Ethiopia; [19]
  - (iv) cattle breeding activities for trade. [20]
- *Schedule D.* Income from agricultural activities, i.e. the cultivation and/or development of land and/or the harvesting of any crop from land including the raising and breeding of livestock on such land (but excluding items (i), (ii) and (iv) above). [21]

Taxes were calculated on the amount of income within each category subject to income tax. There was no aggregation of the income of the Schedules and each Schedule had its own tax rates. This situation has remained unchanged. [22]

## 2. The post 1974 tax reform and the effects of land reform on Schedule B

The income disparity between the lowest income earning groups and the highest was wide. [23] However, it is the issue of land ownership where everything which is connected with the underdevelopment of the country culminates. As Robert S. McNamara, President of the World Bank, stated at the IMF-World Bank Meeting in 1972:

*"When the highly privileged are few and the desperately poor are many . . . and when the gap between them is worsening rather than improving . . . it is only a question of time before decisive choice must be made between the political costs of reform and the political costs of rebellion."* [24]

The above statement was true in Ethiopia prior to 1974. There were millions without land but there were individual landlords whose aggregate land holding was half of, for instance, the Netherlands. Land was concentrated in the hands of the royal family, the church, the nobility and their associates, i.e. the same group which exercised the political power. Thus the owners of real estate were also the most important rental recipients. However, either because of the lack of political will or of the lack of compliance of tax laws, the amount of revenue derived by the State from Schedule B was insignificant. If the Haile Selassie Government had enforced its tax legislation, this would have increased the total tax revenue considerably. About 40 percent of the income of the landlords would have been transferred to the Treasury by virtue of Schedule B alone. [25]

The land reform that took place in Ethiopia was something quite different in its depth and magnitude from any other that has so far occurred in Africa. It is believed to be comparable to the agrarian program of the Russian Bolshevik Party of 1917, [26] although the issue of implementation is, however, the crucial test. The land reform law did not merely limit the size of landholdings to 20 hectares, but it did away with the private ownership of land by absentee landlords and to a great extent with the system of tenancy in areas where absentee landlordism was chronic, especially in the southern part of Ethiopia. In addition, no private farmer is now allowed to hire a laborer and the Government has recently issued a collectivization program which in principle abolishes private ownership of land. There is, however, great skepticism and caution about the implementation thereof.

Due to the land reform and nationalization of urban land and buildings, the government has become the most important landowner. As a result, the tax structure related to Schedules B and D has been drastically changed. The principal tax proclamations which amended the tax law are the following:

a) Rural Land Use Fee and Agricultural Activities Income Tax Proclamation No. 77/1976;
b) Rural Land Use Fee and Agricultural Activities Income Tax Amendment Proclamation No. 152/1978, and

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14. Income Tax Proclamation 1961, Art. 7(a) cum Art. 4(a).
15. Id., Art. 4(b) and Art. 10(a) as amended by Proclamation 255/1967, Art. 2(B)(b).
16. Id., Art. 4(c) and Art. 12(a) Income Tax (Amendment).
17. Id., Art. 3(d) as amended by Income Tax Amendment Proclamation 1967, Art. 2(i).
18. Id., Art. 2(a)(ii).
19. Id., Art. 2(a)(iii).
20. Id., Art. 2(a)(iv).
21. Income Tax Proclamation 1963, Art. 3(d) as amended by Proclamation No. 255/1967, Art. 2A.
22. Income Tax Proclamation 1963, Art. 5.
23. This disparity can best be illustrated from the following facts. While the lowest wage was about 18.2 birr per month, the range of basic salaries within the senior management ranged between 4,000 birr to 7,000 birr (exclusive of other allowances) for Ethiopians and about 10,000 birr for skilled expatriates. One way of distributing income often suggested by many persons is to use the fiscal instrument for imposing higher taxes at progressive rates against the high income groups. See Y. Mekbib, *The Impact of Volitional and Institutional Factors on Income Taxation in Ethiopia*, M. Phil. thesis (unpublished), University of East Anglia, June 1979.
24. See R.M. Bird, "Public Finance and Inequality", *Finance and Development*, 11 (7) (March 1974), p. 2.
25. Mekbib at 301-302.
26. Raul Valdes Vivo, *Ethiopia the Unknown Revolution* (Crudad de la Habana: Editorial de Ciencias Sociales, 1977), p. 94; Navina and David Ottaway, *Ethiopia, Empire in Revolution* (London: African Publishing Company, 1974), p. 8.

## ORGANIZATION OF THE ECONOMY

*Economic organizations operating in rural areas (i.e. outside the boundaries of a municipality or a town)*

| | |
|---|---|
| *Agriculture:* | Agricultural cooperatives in peasant state enterprises to farm state-owned farms. |
| *Industry:* | Handicraft cooperatives engaged in small scale cottage crafts and industrial activities. |
| *Mining:* | State and foreign cooperation enterprises to develop the mineral and oil potential of the country. |

*Urban based or resident economic organizations engaged in predominantly economic activities in rural and urban areas.*

| | |
|---|---|
| *Private:* | Co-operatives.<br>Partnerships.<br>Joint ventures.<br>Private limited organizations. |
| *Mixed:* | Joint venture enterprises to facilitate international industrial cooperation between state and foreign private or state investors. |
| *Wholly state owned enterprises:* | State enterprises to engage in key industrial, mining, agricultural, commercial, trading and other economic activities. |

c) Income Tax Amendment Proclamation No. 155/1978.

The new laws do not, however, expressly state that Schedule B is to be omitted and that Schedule D is to be replaced by a new Schedule D. Under the new laws, income derived from the following sources is subject to tax:

a) Income or benefits in kind from employment, [27] (Schedule A);
b) Income from any trade, business, profession or vocation and from all other sources not specifically mentioned [28] (Schedule C);
c) Income from dividends distributed to shareholders; [29]
d) Income from chance winnings; [30]
e) Income from royalties; [31]
f) Income from services rendered to persons or organizations in Ethiopia by persons or organizations from abroad. [32]

### 3. Taxable persons

Prior to 1978, income tax was paid by all persons, i.e. individuals and all forms of associations, [33] including partnerships but excluding entities with limited liability like joint stock companies. [34]

Now, in the post-1978 legislation, the taxable entity is the "*organization*". The "*organization*" is defined as "any government or privately owned juridical person or association that carries out business activities excluding a cooperative society". [35] However, the types and legal aspects of such organizations are not spelled out in any law, but it may be assumed that joint venture and state enterprises (companies) are now included.

The following provides a brief description of the Ethiopian tax structure on income from various taxable sources.

## B. Income from employment (Schedule A)

### 1. Taxable source

Tax under Schedule A is payable on income in cash or in kind from employment including salaries, wages, allowances, pensions, directors' fees and other personal emoluments etc., [36] unless exempted by the Minister of Finance. The tax is therefore imposed on payments in cash and benefits in kind arising from a contract of employment.

Wages and other employment income received by a person *not* working in Ethiopia are considered to have their origin *outside* Ethiopia and are thus not subject to tax. [37] Persons who remain in Ethiopia for more than an aggregate of 183 days in any twelve-month period are liable for taxes due under Schedule A from the beginning of their stay. [38]

Pensions and other personal emoluments are without exception subject to tax under Schedule A. [39]

Benefits in kind are included in taxable income. There is no guideline for computing the value of benefits in kind, so that valuation of such benefits has to be approved by the Income Tax Authority.

### 2. Tax rates

The tax on income from employment over 50 birr shall be levied and collected monthly according to Schedule A at the following rates:

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27. Income Tax Amendment Proclamation No. 155/1978, Art. 2 (a) cum Income Tax Proclamation 1963, Art. 4(a).
28. Id., Art. 2(b) cum Income Tax Proclamation 1963, Art. 4(c).
29. Id., Art. 2(c).
30. Id., Art. 2(d).
31. Id., Art. 2(e).
32. Id., Art. 2(f).
33. Which according to Art. 404 of the Ethiopian Civil Code is defined as a group formed between two or more persons with a view to obtaining a result other than the securing of profit sharing.
34. Income Tax Proclamation 1961, Art. 3(b).
35. Income Tax Amendment Proclamation No. 155/1978, Art. 2(1) cum Income Tax Proclamation 1961, Art 3(a) as amended.
36. Id., Art. 4(a) cum Arts. 6 and 8.
37. See also R.C. Means, Materials for Public Law (Faculty of Law, H.S.I.U., Addis Ababa, 1966), p. 24.
38. Income Tax Regulations 1962, op. cit., Art. 11.
39. Income Tax Proclamation No. 173 of 1961, op. cit., Art. 4(a).

| Taxable income per month (in birr) | Tax rate on every additional slice of income (%) |
|---|---|
| 50 - 250 | 10 |
| 250 - 500 | 13 |
| 500 - 750 | 19 |
| 750 - 1,000 | 24 |
| 1,000 - 1,250 | 29 |
| 1,250 - 1,500 | 34 |
| 1,500 - 1,750 | 39 |
| 1,750 - 2,000 | 44 |
| 2,000 - 2,250 | 49 |
| 2,250 - 2,500 | 54 |
| 2,500 - 2,750 | 59 |
| 2,750 - 3,000 | 64 |
| 3,000 - 3,250 | 69 |
| 3,250 - 3,500 | 74 |
| 3,500 - 3,750 | 79 |
| 3,750 and over | 85 |

Compared to the pre-1974 situation the tax rate has almost doubled for persons deriving income of about 1,000 birr a month and it is more than three times that of the previous rate at the highest income bracket. It is not, however, clear why the Government has preferred the progressive rate method of taxing higher income groups when it has in fact put a ceiling on wages by administrative decision. Whether this policy of imposing high tax rates is desirable when there are neither employees earning the taxable amount nor even the possibility of earning such an amount is an arguable point. [40]

### 3. Deductions

The family circumstances of the taxpayer are not given any consideration under Schedule A. Contributions to provident, savings or pension funds as well as payments made at the termination of a contract of employment are deductible.

The following categories of payments are excluded from computation of income taxable under Schedule A:

(i) actual cost of medical treatment of employees provided by the employer; [41]

(ii) allowances in lieu of means of transportation granted to employees in accordance with Government regulations or under the contract of employment; [42]

(iii) travelling expenses incurred while on duty paid to employees by the employer; [43]

(iv) compensation for reasonable amounts of travelling expenses incurred by employees recruited from other than the place of employment on joining or terminating employment or in connection with their leave. [44]

### 4. Exemptions

The following are exempt from Schedule A tax:

(a) the first 50 birr of income from employment; [45]

(b) employment income received from abroad by persons present in Ethiopia representing foreign business or other persons not doing business in Ethiopia, who are not employed or retained by any employer in Ethiopia, remaining in Ethiopia less than an aggregate of 183 days in any one year. [46]

## C. Rural land use fee (formerly Schedule B)

### 1. Rural land use fee rates

Rural land, i.e. land outside the boundaries of municipalities and towns [47] which has been declared to be under public ownership, is subject to a land use fee payable at the following rates:

(a) Every farmer [48] who is a member of an agricultural producers' cooperative is obliged to pay 5 birr; [49]

(b) A farmer who is not a member of an agricultural producers' cooperative is charged 10 birr; [50]

(c) Every Government agricultural organization pays 2 birr per hectare on the total of its holdings. [51]

The above implies that the effective ownership of rural land is with the Government and a use fee or rent, as the case may be, is paid for the right to possess or use the land. The land use fee payable by individual farmers whose annual agricultural income is below 1,200 birr and who are members of an agricultural producers' cooperative is collected by the local tax collector [52] (i.e. by a farmers' association or any person authorized by the Inland Revenue Agency (IRA) [53]) every year between the first of Tahsas (December) and 30th of Miazia (April). [54] Farmers' associations or any persons authorized by the Inland Revenue Agency are paid two percent of the amount of the collection they make. [55]

However, rural land use fees from Government agricultural organizations and farmers whose annual agricultural income exceeds 1,200 birr are collected by the tax office, [56] i.e. the Inland Revenue Agency of the Ministry of Finance, and any Provincial, "Awraja" or "Woreda" income tax office, as well as any other office which the IRA may authorize in writing to implement the Proclamation. [57]

40. The same argument can be made for the taxing of agricultural land or income in a predominantly peasant society.
41. Income Tax Regulations 1962, Art. 4(a).
42. Id., Art. 4(b).
43. Id., Art. 4(c).
44. Id., Art. 4(d).
45. Income Tax Proclamation No. 173/1961, Art. 7 (b) as amended by Income Tax Amendment Proclamation No. 155/1978, Art. 3(b)(1).
46. Income Tax Proclamation No. 173/1961, Art. 18(d).
47. Rural Land Use Fee and Agricultural Activities Income Tax Proclamation No. 77/76, Art. 2(2).
48. A farmer shall mean any individual farmer or one who farms land in common with others, any private organization or association or any government agricultural organization other than agricultural research station having legal personality.
49. Rural Land Use Fee and Agricultural Activities Income Tax Proclamation No. 77/1976, Art. 8(1) as amended by Proclamation No. 152/1978, Art. 2(1)(1).
50. Proclamation No. 77/1976, Art. 8(2) as amended by Proclamation No. 152/1978, Art. 2(1)(2).
51. Proclamation No. 77/1976, Art. 8(3).
52. Id., Art. 10(2)(b).
53. Id., Art. 2(8).
54. Id., Art. 10(1).
55. Id., Art. 44.
56. Id., Art. 10(2).
57. Id., Art. 2(7).

## 2. Rural land use fee and rural development

The overall concepts of rural development, regional autonomy, etc. cannot be separated from the financial, political, economic, legal and administrative relationships between the central authority and institutions of local government and rural development.

The municipalities and local authorities or the rural organizations do not have substantial financial autonomy to perform the duties which they have been delegated to undertake. The central government collects income earned from land and other sources located in rural areas. However, the country's funds are not fairly distributed.

If ownership of land is primarily in the hands of the State, it has the special responsibility of redistributing the national wealth more equitably. [58]

## D. Income from business profits (Schedule C)

### 1. Taxable source and taxable subjects

Income from business profits is subject to a tax if derived by individuals, associations or incorporated bodies. The tax is imposed on gains accrued from economic activities except [59] those derived from humanitarian, cultural, religious and social activities.

Schedule C is also intended to apply to all sources of income not covered by the other Schedules including income from occasional rental of property. [60]

It is worth emphasizing that for tax purposes no distinction is made between a branch and subsidiary. However, non-residents trading in Ethiopia through an agent are jointly responsible with the local agent for the filing of returns and for the payment of income tax which may be due by such non-resident. [61] Moreover, no payment of any kind made by an Ethiopian branch to its foreign head office or by an Ethiopian company to its foreign parent or to another affiliated foreign company is accepted as a deduction from gross income unless it is a payment for services actually rendered [62] and this service was necessary for the business and could not be performed by other persons or bodies or by the business itself at a lower cost. [63]

**BASIC INFORMATION**

*Area:* 1,211,900 square kilometers
*Population:* 30 million (approximately) with more than 82 different nationalities
*Religion:* predominantly Christian and Muslim
*Population growth rate:* 2.5% per annum
*Average rate of agricultural production:* 2%
*Population distribution:* 11.8% urban, 88.2% rural
*Annual growth rate of urban population:* 6.6%
*Per capita income:* U.S.$ 80
*Illiteracy rate:* about 85%
*Currency:* 1 Eth. birr. = U.S.$ 2.071 (August 1979)
*Communication and transport system:* About 80 percent of the people live about a day's walk from an all-weather road.

### 2. Individual income tax rates

Individuals who derive income under Schedule C are subject to the following rates of tax:

| *Annual amount of income (in birr)* | *Rate* |
|---|---|
| Under 300 | 10 birr |
| 300 - 500 | 18 birr |
| 500 - 700 | 24 birr |
| 700 - 900 | 40 birr |
| 900 - 1,200 | 70 birr |
| | *plus a percentage of each additional slice* [64] |
| 1,200 - 3,000 | 11 |
| 3,000 - 6,000 | 14 |
| 6,000 - 9,000 | 20 |
| 9,000 - 12,000 | 26 |
| 12,000 - 15,000 | 33 |
| 15,000 - 18,000 | 40 |
| 18,000 - 21,000 | 47 |
| 21,000 - 24,000 | 54 |
| 24,000 - 27,000 | 61 |
| 27,000 - 30,000 | 68 |
| 30,000 - 33,000 | 75 |
| 33,000 - 36,000 | 82 |
| Over 36,000 | 89 |

One of the main reasons for doubling and tripling the tax rate payable by persons in high income brackets might have been to narrow the gap of income inequality. But this objective has theoretically been achieved by the nationalization of land, buildings and industries and by putting a maximum ceiling on wages and property holdings.

### 3. Taxable legal entities: "organizations"

As was explained in the Introduction to this section, "organizations" are subject to income tax.

Art. 4(c) of the 1961 Proclamation provides:

"... [E]very ... body [65] having an income as defined herein [i.e. in Art. 3(c)] is liable to pay income tax thereon ... on income from any trade, business, profession or vocation and from any activity mentioned in subparagraphs (i), (ii) and (iii) of Art. 3 (d) hereof and from any interest and from *all other sources not specifically mentioned* in paragraphs (a), (b) and (d) of this Article 4."

58. The writer is of the opinion that the Ethiopian fiscal system is not designed to promote rural development. It encourages centralization rather than decentralization. Moreover, it is an impediment to the basic principles of regional autonomy or self-rule. There can be no autonomy without a granting of power to the administrative agencies of the region to raise revenues from regional sources.
59. Income Tax Proclamation No. 173/1961, Art. 4(c).
60. Income Tax Amendment Proclamation No. 155/1978, Art. 5(b) cum Income Tax Proclamation No. 173/1961, Art. 12(d).
61. Income Tax Proclamation 1961, Art. 36(b).
62. Id., Art. 18(a).
63. Id., Art. 18(b).
64. Income Tax Amendment Proclamation No. 155/1978, Art. 5(a)(b)(ii) cum Income Tax Proclamation 1961, Art. 12(b).
65. "Body" means any incorporated body with limited liability. This generally refers to public and private companies with limited liabilities. See Income Tax Proclamation No. 173/1961, Art. 3(a).

However, Art. 3(a) of Proclamation 173/1961 is deleted and replaced by Art. 2(i) of Tax Proclamation No. 155/1978 which provides:

"Organization shall mean any government or privately owned juridical person or association that carries out business activities excluding a cooperative society."

Any corporate body which carries out business activities therefore is considered to be an organization. It is not clear, however, whether such organizations are legally different from the business organizations formed under the 1960 Commercial Code or whether this change is merely a cosmetic one, replacing "company" by "organization". It appears that this change may be intended to pave the way for the imposition of tax on state enterprises, joint ventures, or farmers' organizations that are separate legal entities.

*a. Tax rates*

The tax rate payable by organizations as defined above is fifty percent. 66

*b. Deductions*

(i) Ordinary expenses

The general rule is that all expenses paid or incurred wholly, necessarily and exclusively for the purposes of creating income are deductible. No expenditure not wholly and exclusively incurred for the purpose of producing the income is allowed as a deduction. 67

The following expenses are deductible from gross income in calculating taxable income under Schedule C:

- the direct cost of producing the income, such as the direct cost of manufacturing and trading operations, of professional and vocational occupations, of exploitation of woods and forestry and so on; 68
- general and administrative expenses connected therewith; 69
- depreciation, allowed under Articles 22 through 24 of the Income Tax Regulation; 70
- premiums payable on insurance directly connected with the activity chargeable under Schedule C; 71
- commissions paid for services rendered to businesses or to persons or bodies engaged in a professional or vocational occupation, provided that:
  (a) said services were in fact rendered; 72 and
  (b) the amount paid as commission for said services correspond to the normal rates paid by other businesses or persons or bodies similarly situated for similar services rendered in similar circumstances; 73
- bad debts, 74 but not losses unconnected with or not arising out of the activity of the enterprise 75 or losses recoverable by insurance or contract of indemnity. 76

(ii) Depreciation allowance for "capital" expenses

The annual rates of depreciation for capital expenditure are as follows:

- buildings: five percent;
- machinery: sixteen percent for the first year and twelve percent thereafter;
- furniture: ten percent;
- motor vehicles: twenty percent.

In certain cases higher allowances may be approved by the Income Tax Authorities if they are justified in respect to the probable life of the asset. 77

Unless otherwise specifically prohibited by law or otherwise rejected by the Internal Revenue Agency, the deduction and depreciation method which applies to legal entities also applies to individual and small businesses.

## 4. Investment exemptions

In order to encourage foreign investment in Ethiopia the Haile Selassie Government issued various laws. These were the following:

(i) Notice No. 10 of 1950;
(ii) Investment Decree, 1963; and
(iii) Investment Proclamation 1966.

The above laws are still in force.

*a. Exemptions from profits tax*

The foreign investment laws of Ethiopia currently in force, inter alia, provide a five year tax exemption period for newly established agricultural, industrial, mining, transport and tourist enterprises which invest about two hundred thousand birr in Ethiopia prior to the commencement of their operation.

An enterprise which invests an additional 200,000 birr in an extension or expansion of an existing enterprise may be exempted by the Minister of Finance from the tax on income derived from the additional investment for an additional period of five years from the date of the commencement of such operations, provided, however, that the new extended or the expanded facility is operated as a separate technical unit with separate accounts and is earning a separate income. 78

*b. Exemption from customs and import duties of raw materials and machinery*

Moreover, agricultural and industrial machines, implements appliances, or parts thereof, which are imported by a person or enterprise having juridical personality for exclusive use in agricultural and industrial enterprises, are exempt from the payment of customs import duties, transaction taxes on imports, municipal taxes and all

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66. Income Tax Proclamation No. 173/1961, Art. 12(c) as amended by Income Tax Amendment Proclamation No. 155/1978, Art. 5(b). Note that the maximum tax rate for individuals or non-organizations under Schedule C is higher than for organizations.
67. Income Tax Proclamation 1961, Art. 16 cum Income Tax Regulation 1962, Art. 17(a).
68. Income Tax Regulations 1962, id., Art. 16(a).
69. Id., Art. 16(b).
70. Id., Art. 16(c).
71. Id., Art. 16(d).
72. Id., Art. 16(c)(i).
73. Id., Art. 16(e)(ii).
74. Id., Art. 16(f).
75. Id., Art. 17(b)(vii).
76. Id., Art. 17(b)(viii).
77. Id., Art. 24(b).
78. Id., Art 19(a) see also Investment Decree 1963, Art. 5(2) as amended by Investment Proclamation 1966, Art. 9. cum Income Tax Proclamation 1961, Art. 19(b).

other taxes and duties levied on imports: *provided, however that similar goods are not being produced within* Ethiopia. The Minister of Finance is authorized to issue regulations designating, by reference to items of the Customs Tariff, all goods which are subject to exemption and specifying declaration forms which shall be submitted to the Customs Administration by persons claiming the exemption. [79]

c. *Exemption for construction material for industrial enterprise*

Furthermore, upon the proposal of the Investment Committee, the Minister of Finance is authorized to grant exemption from payment of customs import duties, transaction taxes on imports, municipal taxes and all other taxes and duties levied on imports, with *respect to buildings, structural and other construction material* provided that such building, structural and other construction material is being imported for direct and exclusive use in construction *destined to house industrial enterprises* but not for office or living quarters; and provided, further, that similar materials are not being produced within Ethiopia. [80]

d. *Exemption for packaging materials*

Packaging materials and containers imported and used for the export of any goods manufactured locally are also exempt. [81]

e. *Export duty relief*

Goods manufactured locally destined for export are exempt from export duties and transaction taxes on exports for a reasonable period of time if such exemption is found necessary to assure the competitive position of these goods in export markets. [82]

The investment laws authorize the National Bank of Ethiopia to make available foreign exchange necessary to assure:

(i) The remittance of the profits of foreign investors to their countries of origin; [83]
(ii) The repatriation of the net proceeds belonging to a foreign investor upon partial or total sale or liquidation of his investment; [84]
(iii) The payment of the interest and the repayment of approved foreign loans contracted by enterprises; [85]
(iv) The remittance of the savings of foreign personnel employed in Ethiopia by investors; [86]
(v) The purchase of replacement, spare parts and other materials and goods required in connection with their investment operations. [87]

f. *Other exemptions*

The following categories of income are, inter alia, exempt from income tax:

(i) income from interest received by persons on bank accounts; [88]
(ii) income paid to foreign re-insurers. [89]

## E. Income from agricultural activities (Schedule D)

### 1. Taxable source

Under the new laws, "agricultural activities" mean: the cultivation or development of rural land by any means and with the aid of any implement, regardless of whether or not the farmer processes it further by industrial means, the harvesting of crops as well as the breeding of livestock on such land, but excluding the following:

(i) the exploitation of woods and forests for wood lumbering purposes; [90]
(ii) the processing of agricultural crops by a natural or juridical person other than the farmer who produces such crops; [91]
(iii) other activities relating to agricultural forestry, breeding of cattle or maintaining pasture land in cases where said activities shall be deemed to be registered as commercial activities and pursued or conducted by a trader or a business organization, in accordance with the provisions of the Commercial Code of Ethiopia, and where the same is the principal activity; [92] and
(iv) notwithstanding the Cattle Tax Proclamation No. 142 of 1954, breeding animals for domestic use. [93]

### 2. Taxable subjects

a. *Individuals: farmers*

(i) Declaration of income

Each farmer has the duty to declare on the form issued by the Internal Revenue Agency, the amount of gross annual income he realized. The tax due thereon is payable to the nearest tax collector or tax office between the 1st of Tahsas (December) and the 30th of Miazia (April) or 30 days from the date of the realization of the income. [94]

Taxpayers are registered according to their annual declaration. Every tax collector has the duty to register individual farmers as well as those members of agricultural producers' cooperatives in the following categories:

— annual gross income up to 600 birr; [95]
— over 600 but not exceeding 900 birr; [96]
— over 900 but not exceeding 1,200 birr; [97]
— over 1,200 [98] but not exceeding 6,000 birr.

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79. Transaction Taxes Proclamation 1963, Art. 6(a)(1).
80. Id., Art. 6(a)(2).
81. Id., Art. 6(f).
82. Id., Art. 12(a) cum Investment Proclamation No. 242/1966, Art. 7.
83. Investment Proclamation No. 242/1966, Art. 8(1) cum Investment Decree 1963.
84. Id., Art. 8(2).
85. Id., Art. 8(3).
86. Id., Art. 8(4).
87. Id., Art. 8(5).
88. Id., Art. 18(c).
89. Id., Art. 18(f) cum Proclamation No. 155/1978, Art. 2(9).
90. Id., Proclamation No. 77/1976, Art. 9(a).
91. Id., Art. 9(b).
92. Id., Art. 9(c).
93. Id., Art. 9(d).
94. Proclamation No. 77/1976, Art. 13.
95. Id., Art. 14(1).
96. Id., Art. 14(2).
97. Id., Art. 14(3).
98. Id., Art. 14(4).

(ii) Assessment

The above taxpayers are assessed by estimation of the potential crop yield which estimation is valid for a period of three consecutive years but such tax must be paid annually.[99] Loss of a harvest due to difficulties in connection with or damage to the agricultural activity therefore is subject to relief that may be granted by the Ministry of Finance.[100]

The tax office has the responsibility of assessing and collecting taxes on income over 600 birr but not exceeding 6,000 birr.[101]

A farmer who has an income of over 6,000 birr is required to keep books of account and supporting documents in accordance with the directives issued by the tax office.[102] In such cases taxes are assessed on the basis of the taxpayer's annual return unless they are either unacceptable for the tax office in which case they will be assessed by estimation which is often arbitrary.[103]

The tax is assessed on the aggregate of the income realized or deemed to be realized from two or more agricultural activities, subject to tax under the new tax.[104]

(iii) Tax rates

Any farmer whose annual income from agricultural activities does not exceed 600 birr pays 10 birr.[105]

Moreover, an additional tax on income exceeding 600 birr is levied at the following rates:

| *Annual taxable income in birr* | *Tax rate on every additional slice of income (%)* |
|---|---|
| 600 - 1,200 | 10 |
| 1,200 - 3,000 | 11 |
| 3,000 - 6,000 | 14 |
| 6,000 - 9,000 | 20 |
| 9,000 - 12,000 | 26 |
| 12,000 - 15,000 | 33 |
| 15,000 - 18,000 | 40 |
| 18,000 - 21,000 | 47 |
| 21,000 - 24,000 | 54 |
| 24,000 - 27,000 | 61 |
| 27,000 - 30,000 | 68 |
| 30,000 - 33,000 | 75 |
| 33,000 - 36,000 | 82 |
| 36,000 and over | 89 |

(iv) Deductions

No deductions are allowed for taxpayers deriving income below 1,200 birr. However, taxpayers earning above this figure may on request deduct in whole or in part:

(a) any fee[106] which includes the rural land use fee;
(b) all expenses which are necessary and have been incurred especially and directly for the realization of the annual income;[107] and
(c) depreciation of movable and immovable fixed assets used in the agricultural activity to be deducted in accordance with the Income Tax Regulations 152/1962 or Regulations to be issued by the Minister.[108]

However, the tax office may refuse to accept the declaration as well as expenses demanded to be deducted from the gross income unless they are supported by satisfactory evidence.[109]

It is not clear why 1,200 birr is the figure chosen to serve as the line of demarcation. It would appear to be better to have either an estimated deduction system for those taxpayers whose tax liability is assessed by estimation or not to allow any deductions for those who are required by law to keep books but are assessed by estimation on the grounds stated under Art. 21(2) and Art. 22.

(v) Collection

Income tax arising from Schedule E is collected by (a) local tax collectors, or (b) the tax office. The former are mass organizations like peasant associations and presumably cooperatives. The tax office is a local branch of the Ministry of Finance and the government administration. The farmers' associations are allowed to collect only income tax accrued from agricultural activities from a category of farmers whose annual gross income is less than six hundred birr. Whether farmers in such a category should be taxed at all is debatable. The writer believes that it is anti-developmental, unjust and unequitable to tax farmers who are below the poverty line and exist at subsistence level. A better policy would be for the government to provide them with all that they need and impose tax thereon only after they manage to attain a sufficient level of income. Neither the former nor the present government have seriously attempted to use taxation of agricultural income for rural development. While the predominant sources of wealth of the country at present are the land and the rural population, the latter is still suffering from the lack of basic needs and a resulting unequal distribution of resources between the rural and the urban population.

*b. Organizations*

Every organization defined above having income is liable for the payment of income tax. The tax rate for Government agricultural farms or corporate body or organizations is fifty percent of their taxable income.[110]

For purposes of deductions, the tax office has the right to determine whether expenses submitted in accordance with Art. 24 of the Proclamation stated above are to be deducted.[111]

99. Id., Art. 19(1).
100. Id., Art. 19(2).
101. Id., Art. 21(1) as amended by Proclamation No. 152/1978, Art. 4(1).
102. Id., Art. 22.
103. Id., Art. 21(2).
104. Id., Art. 23.
105. Id., Art. 17 as amended by Proclamation No. 152/1978, Art. 2(2).
106. Id., Art. 24(1)(a).
107. Id., Art. 24(1)(b).
108. Id., Art. 24(1)(c).
109. Id., Art. 24(2).
110. Rural Land Use Fee and Agricultural Activities Income Tax Proclamation No. 77/1976, Art. 25(1).
111. Ibid.

### F. Withholding taxes on income from specific sources

In addition to the above, the following new income taxes are withheld at the rates specified below irrespective of whether it is paid to individuals or organizations:

| Income from: | Withholding tax |
|---|---|
| (i) dividends | 25% [112] |
| (ii) chance winnings and tote | 10% [113] |
| (iii) royalties | 40% [114] |
| (iv) service rendered to any person or organization or cooperative society in Ethiopia by any person or organization from abroad. | 10% [115] |

In addition to the payment of taxes on income payable under the relevant Schedules foreign investors are also subject to an additional withholding tax at above rates.

#### 1. Dividends

Under prior law, dividends received by shareholders from bodies incorporated in Ethiopia were exempt provided that amounts paid as dividends were included in the taxable income of the bodies making such payments. [116]

However, as indicated above, dividends are taxed at the rate of 25 percent in the post-1974 tax reform.

#### 2. Royalties

Royalties are taxed at the rate of 40 percent in the post-1974 tax reform. However, there is no definition of the term. This is perhaps one manifestation of the fiscal crisis of the state. The tax authorities seek to impose a tax on income derived from undefined activity. This is bound to encourage tax litigation. There is not even an indication of whether the tax is imposed on a gross or net basis. [117]

#### 3. Tax on payments for services

Income derived from services rendered to any person or organization or cooperative society in Ethiopia by any person or organization from abroad is subject to a 10 percent income tax. [118]

Whether the introduction of the new law is an anti-avoidance measure for commissions paid for services rendered to business stipulated in Art. 16(e) of Income Tax Regulations, 1962 or whether it is a tax imposed on technical assistance services or other categories of services is not clear.

### G. Tax treaties and the avoidance of double taxation

Ethiopia has not as yet concluded any tax treaty for avoidance of "double taxation" on income or capital with any country with the exception of income arising from shipping and air transport. From the viewpoint of foreign investors, therefore, the usual "double taxation" argument applies. It is worth emphasizing to note that in the Ethiopian tax system a tax is imposed on the income derived from activities where the Ethiopian State exercises sovereign territorial including offshore jurisdiction.

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112. Proclamation No. 155/1978, Art. 7(a) cum Art. 2(c).
113. Id., Art. 7(b) cum Art. 2(d).
114. Id., Art. 7(c) cum Art. 2(c).
115. Id., Art. 8(d) cum Art. 2(f).
116. Income Tax Proclamation 1963, Art. 18(f).
117. The post-1974 amendments are so incomprehensible and badly drafted that it would have been much easier both for tax administrators and taxpayers if new tax laws were promulgated altogether.
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# BRAZIL: The Supplementary Income Tax (Imposto Suplementar de Renda) on Dividend Distributions

by Paulo Kantor*

1. The supplementary income tax (Imposto Suplementar de Renda) (ISR) was instituted by Law No. 4,131, of September 3, 1962, and amended by Law No. 4,390, of August 29, 1964, and is presently regulated by the supplementary provisions of Normative Ruling No. 2, of September 12, 1969 (IN 2/69), as amended by Normative Ruling No. 17, of April 30, 1971 (IN 17/71), both issued by the Secretariat of Federal Revenue, and article 348 of the Income Tax Regulations (RIR) approved by Decree No. 76,186, of September 2, 1975.

2. Generally speaking, the profits and dividends which Brazilian companies remit to individuals or entities resident or domiciled abroad are subject to the withholding of income tax at source at the rate of 25 percent, in accordance with articles 344-1 and 343(a) of the RIR.

3. Regardless of the above form of taxation, when the average of profits or dividends remitted during a three-year period exceeds 12 percent of the capital and reinvestments capitalized and registered by the Central Bank of Brazil (Central Bank), ISR will be levied *on the excess*, at the following rates:

— remittances over 12 percent and up to 15 percent of the capital and reinvestments: ISR — 40 percent on the excess;
— remittances over 15 percent and up to 25 percent of the capital and reinvestments: ISR — 50 percent on the excess; and
— remittances over 25 percent of the capital and reinvestments: ISR — 60 percent on the excess.

4. Thus, two factors must be considered in ascertaining the existence of excess remittances and of possible ISR to be paid: (i) the average capital of the foreign investor in the Brazilian investment recipient, and (ii) the remittances of profits or dividends abroad, both relating to a specific period of time, i.e. the three-year period.

5. It is worthy of mention that, in spite of the fact that the period of time determining the taxation of ISR is a three-year period, ascertainment of the excess remittances must be made annually, since each year will represent the end of a new three-year period, as shown below:

1st 3-year period 3rd 3-year period

1973 1974 1975 1976 1977 1978 ...

2nd 3-year period 4th 3-year period

The Editors of the Bulletin for International Fiscal Documentation are proud to publish this article on the Brazilian Supplementary Income Tax by Mr. Paulo Kantor. However, this tax is only part of the Brazilian corporate income tax system which consists of the following taxes:

*Corporate income tax* on the income of legal entities: normal rate, 30 percent, but for corporations which have opted for consolidated returns, 32 percent.

*Profit distributions tax* at a rate of 5 percent on all profit distributions of legal entities including remittances by Brazilian branch offices to their foreign head offices.

*Tax on excess reserves* at a rate of 25 percent on any increase of a corporation's reserve funds above a sum equal to its paid-in capital (as adjusted for inflation). A number of reserve funds are not considered in computing the tax.

*Supplementary income tax*, which is the subject of this article. Note that this tax also applies to branch profits of foreign corporations.

See for more detailed information our loose-leaf publication, *Corporate Taxation in Latin America.*

When due, ISR must be paid within 30 days from the end of the three-year period in which the excess remittance abroad has been verified.

6. The average capital of the three-year period must be computed in accordance with the number of days in which the capital and capitalized reinvestments of the foreign investor have actually remained in the Brazilian company within the three-year period, in accordance with the registrations effected by the Central Bank.

The investments pending registration at the Central Bank may be included in the calculation of the average capital of the three-year period, from the accounting entry of the Brazilian company which received the

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investment. A later readjustment, if necessary, will have to be made after the respective registration by the Central Bank.

**Example I**

*1st year*

foreign capital registered at the Central Bank . . . . . . . . 75

*2nd year*

foreign capital registered at the Central Bank . . . . . . . . 75

*3rd year*

foreign capital registered at the Central Bank . . . . . . . . 150

$$\text{Average capital of the 3-year period} = \frac{\overset{\text{(1st year)}}{(75 \times 365\ \text{days})} + \overset{\text{(2nd year)}}{(75 \times 365\ \text{days})} + \overset{\text{(3rd year)}}{(150 \times 365\ \text{days})}}{3\ \text{years}\ (365\ \text{days} \times 3)}$$

$$= \frac{27{,}375 + 27{,}375 + 54{,}750}{1{,}095\ \text{days}} = \frac{109{,}500}{1{,}095} = \underline{100}$$

7. For effects of ISR taxation, the average amount of the profits or dividends remitted abroad in the three-year period may not exceed 12 percent of the average capital of the same period. Thus, in Example I, for an average capital of *100*, the average of the remittances may reach up to 12 (12 percent) at the end of the three-year period, without ISR being due *(the average of 12 percent* corresponds, of course, to amounts *that total 36 percent* of the average capital in the three years computed).

**Example II**

| | Capital | Remittances permitted | |
|---|---|---|---|
| 1st year | 75 x 12% | 9 | |
| 2nd year | 75 x 12% | 9 | |
| 3rd year | 150 x 12% | 18 | |
| | 300 | 36 | |
| Three-year period (average amounts) | 100 (see Example I) | 12 | $\frac{(9+9+18)}{3\ \text{years}} = \frac{36}{3}$ |

As verification of whether or not there are excess remittances is made at the end of the three-year period, the 12 percent limit will not have to be observed for each year, since it is admissable to compensate the shortfall of one year with the excess of another, as follows:

**Example III**

| | Capital | Remittances permitted | Remittances effected | Shortfall | Excess |
|---|---|---|---|---|---|
| 1st year | 75 | 9 | 0 | 9 | 0 |
| 2nd year | 75 | 9 | 11 | 0 | 2 |
| 3rd year | 150 | 18 | 25 | 0 | 7 |
| | | 36 | 36 | 9 | 9 |
| Three-year period (average amounts) | 100 | 12 | 12 | 0 | 0 |

As may be seen, in the above example the annual excesses were absorbed by the shortfalls, without any excess of remittances being verified at the end of the period. A reservation must be made, however, for the fact that compensation is admitted only *between the years of one and the same three-year period.* Shortfalls verified in one three-year period may not be compensated (in case the remittances abroad corresponded to 34 percent of the average capital, for example), by remitting profits or dividends with an excess of 2 percent in the following three-year period, without ISR taxation.

8. The diagram appearing in paragraph 5 shows that the last two years of a three-year period will be the first two years of the following three-year period. Article 41 of IN 2/69, as amended by IN 17/71, specifies that *the remittances of the last two years of a three-year period* will be considered, *in the first two years of the following three-year period*, in the following manner: (i) *if there was no* excess in the previous three-year period, *in the amounts actually remitted*, and (ii) *if there was* an excess of remittances in the previous period, *in the amount corresponding to 12 percent of the average capital of each one of said years.*

9. The practical result of this rule is to make it recommendable, at times, to remit profits or dividends abroad with an excess, in order not to overburden the limit of the following three-year period.

**Example IV**, *without excess remittances:*

| | 1st 3-year period | | | 2nd 3-year period | | |
|---|---|---|---|---|---|---|
| | 1975 | *1976* | *1977* | *1976* | *1977* | 1978 |
| remittances effected | 0 | 0 | 36% | 0 | 36% | 0* |

* (any remittance in 1978 will be an excess and incur ISR taxation)

**Example V**, *with excess remittances:*

| | 1st 3-year period | | | 2nd 3-year period | | |
|---|---|---|---|---|---|---|
| | 1975 | *1976* | *1977* | *1976* | *1977* | 1978 |
| remittances effected | 0 | 0 | 37% (1% excess) | 12% | 12% | (12%)* |

* (availability for remittance in the year 1978, without constituting an excess).

10. Even though it is not adopted by the federal tax authorities, which follow the criterion indicated in alternative (II) below (as per Normative Opinion No. 77/78, of the Coordination of the Taxation System), there is another interpretation of article 41 of IN 2/69, in the sense that only the remittances that exceed 12 percent of the average capital will be reduced to 12 percent in the three-year period following that in which an excess has occurred, the remittances below the same 12 percent being maintained in the amounts actually remitted.

**Example VI**

| | | | Alternative I | | | | Alternative II | | |
|---|---|---|---|---|---|---|---|---|---|
| 1975 | *1976* | *1977* | *1976* | *1977* | 1978 | or | *1976* | *1977* | 1978 |
| 0 | 0 | 37% | 0 | 12% | (24%) | | 12% | 12% | (12%) |
| | (excess) | | | (without excess) | | | | (without excess) | |

# Sri Lanka: Budget 1980

Reproduced below is an extract from the Budget Speech for 1980 presented in November 1979 by Mr. Ronnie de Mel, the Minister of Finance and Planning of the Democratic Socialist Republic of Sri Lanka. The extract only covers the proposed tax changes.

Mr. Speaker, I now come to my tax proposals. A favourable climate for savings, investment and growth has been established by the exchange, monetary and fiscal policies of this Government. A simplified and restructured tax system has been brought into existence with the passage of the Inland Revenue Act No. 28 of 1979. I hope in the near future to present a new and revamped Estate Duty Act and a new Stamp Act. However, there still remain certain areas, where further incentives and relief are required to trigger off productive investment which is the surest foundation for increasing employment and raising the living standards of the people. While we concentrate on investment and growth, the Government is equally conscious of the need to ensure that the fruits of this increased prosperity are shared by as large a number of people as possible. It is with these objectives in view that I now unfold my proposals relating to taxes.

**(A) Taxation of companies**

Mr. Speaker, in order to encourage company formation I reduced the non-refundable tax on companies from 60 percent to 50 percent last year. Even with this reduction, from the point of view of the local investor, the current rate of return on investment in equity capital of limited liability companies, is not attractive when compared to the alternative options available to him. The company form of business organisation should be actively encouraged to attract the small investor into its fold. To achieve this end, not only should investment in equity capital be made more attractive through the prospect of better yields, but the tax concessions to companies should be geared to induce corporate business to become more broad-based. Fiscal policy should be designed to reactivate the capital market which is a valuable adjunct of the financial system in ensuring the flow of funds for investment. There is also the need to attract foreign capital not merely into the Investment Promotion Zone where enterprises are geared to the export market, but outside the Zone as well. If joint investment outside Zone between local entrepreneurs and foreign investors is to be encouraged, then the relevant tax rates should be comparable with those in other developing countries in our region.

*(i) Resident companies*

Mr. Speaker, you will, therefore appreciate that there is a strong case for consideration being given to lowering of the rate of tax on companies, particularly companies which are truly broad-based where even the small investor gets a chance to participate in the investment. We already have a concessionary rate of tax of 40 percent in respect of People's Companies in contrast to the rate of 50 percent applicable to other resident companies. Unfortunately, however, the People's Company concept with its restrictive conditions, has not proved to be popular in this country. Mr. Speaker, with the primary objective of broad-basing limited liability companies. I wish to offer a package of incentives. Firstly, I propose to extend the concessionary rate of tax of 40 percent to cover all public limited liability companies, whose shares are quoted and who make available for purchase by the general public a stipulated minimum percentage of shares. I expect such companies to be public in true sense of the word. Secondly, I also propose to do away with the $33^1/_3$ percent withholding tax on the dividends declared by such companies. Dividends will, however, be taxable in the hands of the shareholders. Thirdly, I propose to exempt completely from tax, the capital gains that arise from the transfer of ownership of shares in such companies. At present capital gains on the transfer of shares in GCEC enterprises enjoy this exemption. Finally, I also propose to exempt from tax, capital gains which arise on the conversion of a proprietary concern or a partnership to a public company that is broad-based. However, this concession will be available only where the assets are transferred to the new company at the valuation of 31st March, 1977, for Wealth Tax purposes. Such a restriction is necessary to prevent attempts at tax avoidance. With the prospect of higher dividends due to the reduction of the rate of tax and the removal of the withholding and capital gains tax. I expect the small saver to participate in the economic progress of the country. I also hope that these measures will help to reactivate the Colombo Share Market and lead to the creation of more broad-based public companies and a full fledged Stock Exchange in due course.

*(ii) Withholding tax on dividends*

Mr. Speaker, I have already announced that the withholding tax of $33^1/_3$ percent deducted at source on dividends will not apply to broad-based companies whose shares are quoted. As regards the withholding tax on all other companies, I propose to reduce the rate to 20 percent.

*(iii) Exemption of dividends*

Mr. Speaker, there is also an anomaly that exists at present in regard to the exemption of dividends from tax. Dividends declared by a company carrying on an exempt undertaking are exempt in the hands of the shareholders in so far as the dividends are declared out of exempt profits during the period of the tax holiday or the year immediately succeeding. This exemption is presently available to every shareholder irrespective of whether such shareholder is an individual, a company or any other person. However, in the case of a company which receives exempt dividends, and pays it out in the form of dividends to its shareholders, such dividends become liable to tax in the hands of the shareholders. This is clearly an anomalous situation. Mr. Speaker, I, therefore, propose to amend the Inland Revenue Act to exempt from tax, dividends which are declared out of exempt dividends received by a company so long as they are paid out as dividends in the year in which the exempt dividends were received or in the year immediately succeeding.

**(B) Taxation of individuals**

Mr. Speaker, the present maximum marginal rate of tax for individuals is 70 percent. High marginal rates induce a greater degree of evasion and compel governments to have recourse to periodic tax amnesties. Amnesties by and large discriminate against the honest taxpayer. Greater compliance with tax laws and less evasion can be induced by reasonable rates of tax. Moreover, high marginal rates can also exert an adverse effect on incentives to work, save and invest. They hamper growth. Mr. Speaker, I, therefore, propose to reduce the maximum marginal rate of tax on individuals to 55 percent. A differential of 5 percent and 15 percent respectively between this rate and 50 percent on ordinary resident companies and 40 percent on broad-based companies, is intended to encourage company formation and growth. I do not expect any significant loss in revenue as a result of this measure, as loss evasion is likely to take place.

**(C) Taxation of terminal benefits of private sector employees**

Mr. Speaker, all public sector employees were exempted from income taxes both on their employment income as well as on their superannuation benefits, with effect from the year of assessment 1979/80. This was done particularly in view of the highly rigid salary structure in the public service, particularly in the management grades, where salaries are well below the level of their counterparts in the private sector. It is my intention now to provide some relief to private sector employees too. This relief will apply to terminal benefits of these employees especially those in the lower ranks who are nearing retirement. Terminal benefits often represent the only saving of their lifetime, the real value of which has unhappily been eroded with inflation over the years.

Mr. Speaker, the terminal benefits which private sector employees receive are now liable at a single rate of tax determined by the average rates for the last three years of assessment, subject to a maximum of 15 percent. I intend adopting a more straightforward and rational system while affording substantial relief to lower rank employees by exempting the first Rs. 50,000 of such benefits from tax altogether. The rates of tax on all terminal benefits, which I propose to levy will be as follows:

| | | |
|---|---|---|
| On the first | Rs. 50,000 | .... Nil |
| On the next | Rs. 25,000 | .... 5% |
| On the next | Rs. 25,000 | .... 10% |
| On the balance | — | .... 15% |

This concession will be made available only if the benefit paid by an employer is on the basis of a scheme under which payments are made to all employees of the enterprise under a common set of rules.

**(D) Charitable institutions**

Mr. Speaker, in the last Budget I reduced the tax rate on religious and charitable institutions from 23 percent to 20 percent. The present position is that a charitable institution is not liable to tax if its assessable income for a year does not exceed Rs. 12,000 whereas if it exceeds this figure the entirety of its income is liable. I propose to grant a measure of relief to these institutions by giving a tax free allowance up to Rs. 12,000 for all charitable institutions in future.

**(E) Wealth tax**

Mr. Speaker, representations have been made to me regarding the hardships caused by the general escalation of property values. Consequently taxpayers, if they are to declare the current true market values of property, will be confronted with substantially increased liability on capital taxes. This increased tax liability is not sufficiently compensated by the increase in incomes from such properties if true market values were to be declared by taxpayers. Wealth Tax has in these circumstances become a highly confiscatory tax, even if the asset were to be put to its optimum use. This is particularly true of immovable properties like houses. I, therefore, propose to provide for the freezing of values of immovable property at their values as on 31st March, 1977 for Wealth Tax purposes. A similar provision will also be made in respect of Estate Duty and Gifts.

**(F) Capital allowances**

Mr. Speaker, last year, I announced my intention to do away with the scheme of lump sum capital allowances for plant, machinery, fixtures and buildings and to replace it with effect from 1st April, 1980 with a new scheme of capital allowances based on a fixed percentage of the cost of acquisition or construction as the case may be, to be written off over a period of years. I allowed the scheme of capital allowances then in existence to continue for a year till 31st March, 1980. This was because I felt that industries starved of machinery and equipment during the last regime should be able to take advantage of the liberalisation policy and modernise and expand their production capacity without undue liquidity problems. Representations have been made to me that the grace period of one year that was granted was inadequate for investors to get down machinery and equipment. I am firmly convinced that in the long term interests of the economy, the lump sum capital allowances should be replaced as proposed last year. Nevertheless, I admit that the time given to take full advantage of the old scheme is insufficient. I, therefore, propose to continue the scheme of capital allowances which was to have ended on 31st March, 1980 for another 2 years only.

**(G) Incentives to employers for the construction of houses**

Mr. Speaker, I wish to provide incentives to employers who contribute towards the easing of the currently acute problem of housing. I propose to make them eligible to claim the monies expended on housing for their employees as "qualifying payments" and hence deductible from their assessable incomes. Employers who construct houses for occupation by employees with a floor area not exceeding 1500 sq. ft. could claim expenditure incurred on the construction of such residential houses as "qualifying payments". In the event of the houses being sold to employees however, such sale proceeds will be taxable as capital gains, since the cost of construction would have been allowed as a deduction.

**(H) Penalties for non-payment of tax in default**

Mr. Speaker, Section 125 (2) of the Inland Revenue Act stipulates the following penalties where any tax due whether under the self-assessment scheme or on an assessment issued by the Department, is not paid by the due date:

1. An automatic penalty of 5 percent of the amount of tax due, if the tax is not paid on or before the due date;
2. Where the tax is not paid before the expiry of 30 days after the tax has begun to be in default, an additional penalty of 5 percent in respect of each further period of 3 months or part thereof during which tax is in default.

The maximum amount leviable as a penalty on tax in arrears is 25 percent per annum of the tax outstanding.

I am of the view that the penalties levied should bear some relation to the prevalent rates of interest. Otherwise as it happens now, even taxpayers who can well afford to pay the tax due, will postpone tax payments and utilise such funds for further investment. Non-compliance has to be taken more seriously, once compliance has been made less burdensome, as I have done, by moderating its incidence. I, therefore, propose to increase the ceiling on the amount of the penalty payable from 25 percent to 50 percent, the penalties increasing by 5 percent for each quarter that tax is in default.

**(I) Tax incentives**

*(1) Property development projects approved by the Urban Development Authority, contract work for Mahaweli Development, import substitution industries of a pioneering nature*

Mr. Speaker, in order to enable high priority national projects such as the Mahaweli and Urban Development to be completed within the target dates, I propose to extend certain tax concessions to new companies as an incentive towards the quick implementation of these projects. Whilst we have already extended every possible concession to GCEC enterprises and export-oriented ventures outside the Free Trade Zone, there is still some need to also consider certain import substitution industries and industries of a pioneering nature for the grant of similar tax concessions. This is necessary if our industrial development is to be more widely and securely based. It is for these reasons that I propose to offer tax concessions to new companies engaged solely in

*(a)* contracts in respect of irrigation works, clearing of lands etc., with the Mahaweli Development Board;

(b) import substitution industries and industries of a pioneering nature;

and approved by the Minister of Finance and Planning.

These companies will be granted a five year tax holiday. Dividends declared out of exempt profits will also be exempt and investment in shares of such companies will be treated as "qualifying payments" enabling the investor to claim relief from his assessable income. To qualify for these concessions, the companies should be broad-based public companies whose shares are quoted in the market.

Tax concessions will also be granted to new companies engaged solely in property development projects recommended by the Urban Development Authority and approved by me. They will be entitled to the same concessions except that the tax holiday on profits and dividends will be for 10 years in their case. Such companies will have to become public companies and get their shares quoted in the share market within two years of commencement of business.

*(2) Foreign Currency Banking Units*

The Central Bank has recently launched Foreign Currency Banking Unit Scheme, with the objective of establishing a full fledged off-shore banking centre in Sri Lanka and making available financial facilities at competitive rates of interest to GCEC enterprises. It is necessary to give every possible incentive to these banking units and I propose to offer the following concessions to them —

(a) Depositors of foreign currency with Foreign Currency Banking Units (FCBU) will be exempted from income tax on their interest income;
(b) Foreign Currency Banking Units will be granted tax exemption on their profits from off-shore transactions and on certain designated on-shore foreign currency transactions.

*(3) A package deal for the gem industry*

Mr. Speaker, smuggling of gems has always been a problem in this country and in every country where gems are found. Exporters of gems through legal channels are offten in a disadvantageous position vis-a-vis the smugglers who offer higher price for gems in the local market. It is also a trade where the primary producer, the miner, has been always forgotten. He is often at the mercy of exploitative middlemen. No scheme evolved for the gem industry up-to-date has given sufficient consideration to the small man — the actual miner and the gem worker. I propose to do what I can to help these categories who really produce the gem wealth of the country. I also feel that there is a great potential for jewellery exports if only the required incentives could be provided. This will provide an opportunity for our traditional craftmen to enjoy some part of the handsome benefits that acucre to the trade.

Mr. Speaker, I, therefore, intend offering the gem and jewellery industry a package deal which will benefit all those in the industry from the miner to the eventual exporter.

It will
(i) ensure a better price to the gem miner;
(ii) channel gem exports through official channels as far as possible; and
(iii) promote the export trade in jewellery.

The policy package will embody the following:

(a) Weekly gem auctions to be conducted by the Chamber of Commerce at chosen locations to encourage miners and dealers to sell their stones, rough as well as cut, in the open market. The Gem Corporation too will be a buyer at these auctions. These auctions will initially be held at Colombo, Ratnapura and Matale.
(b) As an encouragement to miners and dealers to sell through auctions, exemptions from income tax of profits from the sale of stones sold at the auction will be granted. These sales will also be exempt from Business Turnover Tax;
(c) Exemption from income tax will be granted on profits from all gem exports as well. At present, only profits from the sale of gems to the Gem Corporation and from exports made through the Corporation are exempt. Export sales will, however, be subject to Business Turnover Tax at 5 percent;
(d) Manufacturers and exporters of jewellery can avail themselves of the tax concession presently available up to 1983 for small and medium-scale industries and the five year tax holiday available for manufacture for export;
(e) Exports of jewellery will be liable to a Business Turnover Tax of 2 percent.

Mr. Speaker, these are considerable concessions to the gem and jewellery industry. I hope the industry will respond in a positive manner and establish itself as a leading foreign exchange earner for the country.

If despite these concessions, persons still indulge in smuggling, it would be a crime against the nation. I propose, therefore, to introduce severe penalties for infringement of any rules and also provide rewards to informants who bring to our notice such infringements. A fine of 300 percent of the value of the gems will be imposed on anyone detected attempting to smuggle gems or violating gem licence regulations. Informants will be paid a reward of 100 percent of the value of the gems detected on information given by them. The condition on which licences are presently issued by the State Gem Corporation will be strictly enforced both as regards miners as well as dealers in gems. I hope these measures will lead to a reduction in smuggling and the revitalisation to the gem industry.

*(4) Incentives for entrepot trade*

Mr. Speaker, Sri Lanka is located in an advantageous position in relation to both shipping and airline routes and can be, in my opinion, developed as a centre for a lucrative entrepot trade catering to other countries in our region. To attract activities of this nature, infra-structural support in the form of quick and efficient communication links with major cities, a well organised banking system and adequate bonded warehouse facilities are essential. At a time when we are developing these services to ensure the sucess of the Investment Promotion Zone and giving every encouragement to off-shore banking, we must also try to derive the maximum advantage from our investment in these services. I wish, therefore, to include a provision in the Inland Revenue Act, granting exemption from income tax on the profits from entrepot trade in respect of specified commodities. Some of the likely commodities that could be traded on this basis are precious metals and precious stones not mined in Sri Lanka, petroleum products and other primary produce not produced in Sri Lanka.

*(5) Exemption of presidential awards and government awards to inventors*

I also propose to amend the Inland Revenue Act to exempt from income tax cash prizes given together with presidential awards and cash prizes to be given to inventors by the Government with a view to encouraging new research and inventions.

Mr. Speaker, my tax proposals and the incentives I have offered are in line with our basic objectives of investment and quick economic growth. They cost very little in terms of loss of revenue. I expect my pre-budget income tax revenue to come down marginally by Rs. 12 million in respect of corporate taxes and Rs. 18 million in respect of non-corporate taxes. Considering their long-term, or even for that matter, their short-term effects, they should in fact be self-financing by inducing increased production and exports, and less tax evasion. Fiscal policy is not merely a question of taxing regardless of circumstances, incidence of the consequential effects of taxing. As Colbert, one of the greatest Finance Ministers of all time said, "The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least possible amount of hissing".

Mr. Speaker, let me now come to the next set of proposals which will assist me in the task of collecting revenue:

### (J) Withdrawal of tax exemptions from public corporations which are statutorily exempt

Mr. Speaker, I have already referred to the massive investment in public corporations which successive Governments have undertaken, mostly with loan funds, on which interest is payable by the Government. The returns received by Government in relation to the capital employed have been very disappointing, being less than 2 percent. The system of levies on corporations which has been tried out in the past by the Treasury, has led to lack of uniformity and has tended to penalise the relatively more successful corporations, just because they have proved to be more efficient. On the other hand, statutory provisions currently exempt from income tax the profits of certain corporations and statutory boards. Such exemptions may be justified, as in the case of new industrial undertakings, provided the concession is limited to a period of time sufficient to enable them to become viable enterprises. The continuation of these exemptions beyond this period is, however, indefensible. I, therefore, propose to withdraw the present statutory exemption conferred on the National Lotteries Board, Sri Lanka Broadcasting Corporation and on the Sri Lanka Insurance Corporation in respect of its profits from the business of life insurance. These enterprises have now been in existence for a long period of time and are certainly viable enough to meet any normal tax liabilities. The additional income tax revenue I hope to collect as a result would be in the region of Rs. 30 million.

### (K) Non-citizens employed in Sri Lanka

The existing provisions in the Inland Revenue Act confer an exemption on the emoluments arising in Sri Lanka of a non-citizen who being a scientist, technician, expert or advisor is employed by Government or any public corporation or institution approved by me. There is also provision in the Act to exempt foreign personnel employed by the hotel industry.

Mr. Speaker, there is no reason whatsoever why non-citizens of any category should be granted full exemption. The loss to revenue could be considerable. I am of the view that they should be subject to income tax, though not on the basis of the existing rate schedules. I, therefore, propose in future to levy a flat rate of tax at 25 percent on all non-citizens employed in all undertakings. However, employees who have already been granted an exemption under the existing provisions will continue to enjoy the benefit. This scheme of preferential treatment will apply to any non-citizen for three years of employment either at one stretch or in broken periods which aggregate to three years in all. In addition to ensuring that local personnel are sufficiently trained to replace these expatriate personnel as quickly as possible, this will also enable us to save a considerable amount of tax revenue now lost.

### (L) Airport levies

The Embarkation Tax that is levied at our International Airport at present of Rs. 25 per passenger is very low by international standards. I propose to increase the levy to Rs. 100 per passenger.

### (M) Fees levied by the registrar of motor vehicles

*(a) Registration fees for vehicles*

The fees charged at present for the first registration of a motor car, motorcycle or scooter is only Rs. 10 per vehicle. On lorries, buses and tractors the fee levied is only Rs. 20. These fees have remained unchanged for many years. It is proposed to increase the fee for the first registration of vehicles as follows:

Rs. 50 for motor cycles, scooters and three wheelers;
Rs. 200 for motor cars, tractors and other land vehicles; and
Rs. 400 for buses and lorries.

*(b) Annual licence fee on diesel driven passenger cars*

Mr. Speaker, although the fuel prices were raised to partly offset the tremendous losses that were being incurred on its sale, we were compelled to keep the prices of certain fuels like diesel, low enough to soften the impact on the cost of living. However, there is no justification why this price advantage on diesel vis-a-vis petrol should accrue to the owners of diesel operated passenger cars. Hence, I propose to levy a 100 percent surcharge on the current annual licence fee payable on such vehicles.

*(c) Tax on transfer of motor vehicles*

The present transfer tax of Rs. 5,000 in respect of cars less than 17 cwt. and Rs. 10,000 in respect of cars of 17 cwts. or over, was introduced last year in place of the earlier prohibitive tax which discouraged the official transfer of cars. This reduction brought about the desired and intended effect of increasing revenue substantially from Rs. 2 million per year to Rs. 20 million in 1979. With the increase in the price of petrol and slump in the car market, the present rates of tax have once again become high enough to discourage compliance. In view of this, it is proposed to levy a uniform rate of transfer tax of Rs. 2,500 in respect of the first transfer in Sri Lanka of all vehicles other than three wheelers, motor cycles and scootors. These several measures will result in an additional revenue of Rs. 7 million.

### (N) Fees on the issue of passports

The current fee levied by way of stamps for the issue of a passport is Rs. 20 and for the extension of a passport is Rs. 5 per year. These charges have remained unchanged for quite some time, and are totally unrelated to the administrative costs involved.

A fee of Rs. 5 per individual is now charged on persons granted admission to the airport departure lounge and/or viewing gallery. It is proposed to increase this levy to Rs. 10 per person. The additional funds to be collected from these measures are estimated at Rs. 21 million.

It is proposed to revise the fees levied as follows:

| | |
|---|---|
| Issue of passport | Rs. 100 |
| Issue of emergency certificate | Rs. 25 |
| Extension of passport | Rs. 20 per year |

The additional revenue expected is about Rs. 15 million.

### (O) Revision of B.T.T. rates

Services and professions are today subject to BTT mostly at the 1 percent rate. A higher rate of 10 percent applies to tourist hotels. Some of these services cater to the affluent. In the case of certain others, such as the travel agency and Indenting Agency businesses, there has been a remarkable increase in the turnover consequent to liberalisation.

I propose to increase the present rates of BTT applicable to Services and Professions as follows:

| | % |
|---|---|
| Professions | 5 |
| Tourist Hotels | 15 |
| Travel Agencies | 5 |
| Produce Brokers | 5 |
| Advertising | 5 |
| Indenting and Commission Agents | 5 |

The additional revenue is estimated at Rs. 90 million.

### (P) Cigarettes

Mr. Speaker, the yield from tobacco tax has been decreasing for some time, as a result of the increased production of filter as against plain cigarettes and the loose packing of cigarettes. While it is true that a turnover tax on the manufacture of cigarettes operates at the same time as the Tobacco Tax, and would probably recoup some part of this loss, the manufacturers have gained overall, at the expense of State revenue. With a view to recouping this loss as well as to raise additional revenue, I propose to increase the BTT rate on cigarettes from the current 25 percent to 30 percent. The retail prices of all brands of cigarettes will go up as a result by 2 cents per cigarette.

The additional revenue I hope to collect by this measure is Rs. 75 million.

**(Q) Stamp duty**

Under the provisions of the Stamp Ordinance, trust receipts were once liable to be stamped on an ad valorem basis. The rate applicable was the same as for mortgages. Trust receipts were, however, exempted from stamp duty by an amendment to the Stamp Duty Act in 1973. These trust receipts are for very large sums of money and it is my view that these documents should be properly stamped on an ad valorem basis. These transactions, however, are for short-term credit as compared with mortgages which are invariably long-term. In view of this I propose to buy a moderate rate of stamp duty on trust receipts and other credit instruments like pro-notes and letters of guarantee for imports and a slightly lower rate for similar documents for exports. The rates will be as follows:

*(a)* a flat rate of 0.1 percent (Re 1 per every Rs. 1,000) on the value of trust receipts and other credit instruments on imports;

*(b)* a flat rate of 0.05 percent (50 cts. on every Rs. 1,000) on the value of pro-notes and other documents for exports.

In the case of pro-notes for sums below Rs. 10,000 the rate of Re. 1 will be continued.

The additional revenue expected is about Rs. 10 million.

**(R) Import duties**

Mr. Speaker, I am also taking this opportunity to make some changes in import duties which will be gazetted tonight. In the main, these changes will give relief to the hotel industry, the leather making industry and the paper manufacturing industry. I have also eliminated the duty on agricultural implements.

# Sri Lanka: 1980 Budget Proposals

by Dr. M.P. Dominic *

*A new "simplified" and restructured Income Tax Act was brought into effect in May 1979. However, the new Budget proposes to amend this Act with a view to providing further incentives and relief "to trigger off productive investment which is the surest foundation for increasing employment and raising the living standards of the people".*

## I. Taxation of companies

### A. Reduction of company tax rate

Under present law, companies are taxed at a rate of 50 percent. In the case of a "people's company" the rate is reduced to 40 percent. A "people's company" means a company which is resident in Sri Lanka and in respect of which the Assessor is satisfied that:

(i) it is not a private company within the meaning of the Companies Ordinance;

(ii) the number of shareholders of the company exceeds 100 and the nominal value of each share does not exceed 10 Rs.;

(iii) any person may invest in one or more shares of the company at any allotment of shares by the company or in the open market;

(iv) no person either individually or together with his wife or minor children holds, either directly or through nominees, more than 5 percent of the issued share capital;

(v) there are three or more directors each owning one or more shares;

(vi) none of the directors of the company holds office as director of any other people's company; and

(vii) no other company holds any share either directly or through nominees.

However, the "people's company" concept with its restrictive conditions has not proved to be popular in Sri Lanka. The new Budget proposes to extend the concessionary rate of tax of 40 percent to cover all public limited liability companies whose shares are quoted and which make available for purchase by the general public a stipulated minimum percentage of shares.

### B. Reduction of dividend withholding tax rate

At present, dividends paid by resident companies are subject to 33 1/3 percent withholding tax. If the dividends are paid to companies, whether resident or not, the withholding tax is the final tax payable on such dividends. If the dividends are paid to individuals, whether resident or not, the withholding tax is not the final tax; the dividends will be subject to income tax with a credit for the tax withheld.

The new Budget proposes to abolish the withholding tax on dividends paid by public limited liability companies whose shares are quoted and which make available for purchase by the gneral public a stipulated minimum percentage of shares. The new Budget also proposes to reduce the withholding tax on dividends paid by other resident companies to 20 percent.

It may be noted that the 5 percent levy in lieu of estate duty which is deducted, in addition to the withholding tax on dividends, from dividends paid to non-resident companies will remain.

The abolition or reduction of the withholding tax will not benefit individual shareholders; the dividends will continue to be subject to income tax at the rate applicable to them. But these proposals will reduce the effective tax burden on dividends received by companies, whether resident or non-resident; for them the effective

* Attorney-at-law, Sri Lanka.

tax rate (both company tax and tax on dividends) is as follows:

**Effective tax rates (in percent)**

*Quoted companies*

| | Dividends received by resident companies | | Dividends received by non-resident companies | |
|---|---|---|---|---|
| | Present law | Budget proposal | Present law | Budget proposal |
| Company tax | 50 | 40 | 50 | 40 |
| Tax on dividends | 33 1/3 | nil | 33 1/3 | nil |
| Levy in lieu of estate duty | nil | nil | 5 | 5 |
| Effective tax rate | 66 2/3 | 40 | 69 1/6 | 42.5 |

*Other companies*

| | Dividends received by resident companies | | Dividends received by non-resident companies | |
|---|---|---|---|---|
| | Present law | Budget proposal | Present law | Budget proposal |
| Company tax | 50 | 50 | 50 | 50 |
| Tax on dividends | 33 1/3 | 20 | 33 1/3 | 20 |
| Levy in lieu of estate duty | nil | nil | 5 | 5 |
| Effective tax rate | 66 2/3 | 60 | 69 1/6 | 62.5 |

## C. Exemption of dividends paid from exempt dividends

At present, dividends paid by a company from exempt dividends received by it are subject to tax. The new Budget proposes to exempt from tax dividends which are declared out of exempt dividends received by a company so long as they are paid out as dividends in the year in which the exempt dividends were received or in the year immediately succeeding.

## D. Exemption of capital gains arising from transfer of shares

Capital gains that arise from the transfer of shares in public limited liability companies whose shares are quoted and which make available for purchase by the general public a stipulated minimum percentage of shares will be tax exempt.

## E. Exemption of capital gains on te conversion of a sole proprietorship or a partnership in a broad-based public company

Capital gains arising on the conversion of a sole proprietorship or a partnership into a public limited liability company whose shares are quoted and which makes available for purchase by the general public a stipulated minimum percentage of shares will be tax exempt.

# II. Taxation of individuals

## A. Reduction of the maximum marginal rate

The present maximum marginal rate is 70 percent. This will be reduced to 55 percent. The Minister of Finance states:

> High marginal rates induce a greater degree of evasion and compel governments to have recourse to periodic tax amnesties. Amnesties by and large discriminate against the honest taxpayer. Greater compliance with tax laws and less evasion can be induced by reasonable rates of tax. Moreover high marginal rates can also exert an adverse effect on incentives to work, save and invest. They hamper growth. Mr. Speaker, I, therefore, propose to reduce the maximum marginal rate of tax on individuals to 55 percent. A differential of 5 percent and 15 percent respectively between this rate and 50 percent on ordinary resident companies and 40 percent on broad-based companies is intended to encourage company formation and growth. I do not expect any significant loss in revenue as a result of this measure, as less evasion is likely to take place.

This statement may be contrasted with the view taken by the same Minister in his Budget Speech, 1978.

> The previous government, in order to safeguard the new capitalist class which aided and abetted it, reduced personal income tax to 50 percent. In the interests of the common man I am increasing the rate of personal income taxation to 70 percent. Our aim is to maximise taxes on the incomes of capitalist classes that can bear the burden and use such funds to give relief to the common man.

## B. Terminal benefits of private sector employees

Under the existing law terminal benefits of private sector employees are liable to a single rate of tax determined by the average rates for the last three years of assessment, subject to a maximum of 15 percent.

The new Budget proposes to tax them as follows:

| | | percent |
|---|---|---|
| on the first | 50,000 Rs. | Nil |
| on the next | 25,000 Rs. | 5 |
| on the next | 25,000 Rs. | 10 |
| on the balance | — | 15 |

This concession will be made available only if the benefits paid by an employer are on the basis of a scheme under which payments are made to all employees of the enterprise under a common set of rules.

It may be noted that under the present law, public sector employees are exempted from income taxes both on their employment income as well as on their superannuation benefits. This will continue.

# III. Depreciation allowances

At present, all plant, machinery and fixtures acquired before April 1, 1980 are eligible for 100 percent depreciation allowance in the year of acquisition. The straight line method is to be applied to any plant, machinery and fixture acquired on or after April 1, 1980.

The new Budget proposes to extend the 100 percent depreciation allowance in the year of acquisition for another two years, i.e. until March 31, 1982.

## IV. Charitable institutions

The present 23 percent tax rate will be reduced to 20 percent. Further, the first 12,000 Rs. of taxable income will be exempt. At present, such institutions are taxed on their entire income if it exceeds 12,000 Rs.

## V. Wealth tax

For purposes of wealth tax, estate duty and gifts tax, the values of immovable property will be frozen, as of March 31, 1977.

## VI. Exemption from income tax

Will be withdrawn from certain (government) corporations.

## VII. Penalties for non-payment of tax

The current law stipulates the following penalties for non-payment of tax by the due date:
- an automatic penalty of 5 percent of the amount of tax due, if the tax is not paid on or before the due date;
- where the tax is not paid before the expiry of 30 days after the tax has begun to be in default, an additional penalty of 5 percent in respect of each further period of three months or part thereof during which tax is in default.

The maximum amount leviable as a penalty on tax in arrears is 25 percent per annum of the tax outstanding.

The penalty for each quarter in which the tax is in default will be increased by 5 percent and the ceiling on the amount of penalty payable will be increased from 25 to 50 percent.

## VIII. Tax incentives

### A. Construction of houses for employees

Employers who construct houses for occupation by employees with a floor area not exceeding 1500 sq. ft. may claim expenditure incurred on the construction of such residential houses as "qualifying payments". In the event of the houses being sold to employees, such sale proceeds will be taxable as capital gains. It may be noted that "qualifying payments" are deductible from assessable income up to one-third of such assessable income.

### B. Contract work for Mahaweli Development, import substitution industries and industries of a pioneering nature

1. A five-year tax holiday will be granted to new companies engaged solely in:
   - contracts in respect of irrigation works, clearing of lands, etc. with the Mahaweli Development Board;
   - import substitution industries and industries of a pioneering nature;

   and which have been approved by the Minister of Finance and Planning.
2. Dividends declared out of exempt profits will also be tax exempt.
3. Investment in shares of such companies will be treated as "qualifying payments" enabling the investor to claim deduction up to 33 1/3 percent of the taxable income.

To qualify for these concessions, the companies should be broad-based public companies whose shares are quoted in the stock market.

### C. Property development projects approved by the Urban Development Authority

1. A ten-year tax holiday will be given to new companies engaged in such projects.
2. Dividends declared out of exempt profits will also be exempt.
3. Investment in shares of such companies will be treated as "qualifying payments" enabling the investor to claim deduction up to 33 1/3 percent of the taxable income.

To qualify for these concessions, the companies should be broad-based public companies whose shares are quoted in the stock market.

### D. Offshore banking

The Central Bank has recently introduced the Foreign Currency Banking Unit Scheme, with the objective of making Sri Lanka an offshore banking centre and making available financial facilities at competitive rates of interest to GCEC enterprises (i.e. enterprises established in the Investment Promotion Zones).

The new Budget proposes to grant the following incentives for this purpose:
1. Depositors of foreign currency with Foreign Currency Banking Units (FCBU) will be exempted from income tax on their interest income.
2. Foreign Currency Banking Units will be granted tax exemption on their profits and income from offshore transactions and on certain designated onshore foreign currency transactions.

### E. Gem and jewellery industry

The following incentives will be granted:
1. Exemption from income tax will be given to profits from the sale of gems at gem auctions (to be conducted by the Chamber of Commerce).
2. Exemption from business turnover tax will be given to the sale of gems at such gem auctions.

3. Exemption from income tax will be given on profits from all gem exports. At present, only profits from the sale of gems to the Gem Corporation and from exports made through the Corporation are exempt. Export sales, however, will be subject to business turnover tax at 5 percent.
4. Manufacturers and exporters of jewellery can avail themselves of the tax concession presently available up to 1983 for small and medium-scale industries and the five-year tax holiday available for manufacture for export.

However, exports of jewellery will be liable to a business turnover tax of 2 percent.

### F. Entrepot trade

In order to develop Sri Lanka as an entrepot trade centre catering to other countries in the region, exemption from income tax will be given for profits from entrepot trade in respect of specified commodities. Some of the likely commodities that could be traded on this basis are precious metals and precious stones not mined in Sri Lanka, petroleum products and other primary produce not produced in Sri Lanka.

### G. Expatriate employees

A flat rate of tax at 25 percent will apply to all emoluments arising in Sri Lanka of any non-citizen employed in any undertaking. This scheme of preferential treatment will apply for three years of employment either at one stretch or in broken periods which aggregate to three years in all.

At present, expatriate employees in a number of approved undertakings are fully exempt from income tax. Otherwise, they are subject to the normal tax rates which are very high.

### H. Government awards and cash prizes given to inventors

They will be exempt from income tax.

## IX Business turnover tax rates – increase

The tax rates applicable to services and professions will be increased as follows:

| | percent |
|---|---|
| Professions | 5 |
| Tourist hotels | 15 |
| Travel agencies | 5 |
| Produce brokers | 5 |
| Advertising | 5 |
| Indenting and commission agents | 5 |

## X. Stamp duty

Stamp duties are charged in respect of trust receipts and other credit instruments as follows:

(a) a flat rate of 0.1 percent (1 Rupee on every 1,000 Rs.) on the value of trust receipts and other credit instruments on imports;
(b) a flat rate of 0.05 percent (50 cts. on every 1,000 Rs.) on the value of pro-notes and other documents for exports. In the case of pro-notes for sums below 10,000 Rs. the rate of 1 Rupee will be continued.

## IX. Import duties

Import duty relief is given to the hotel industry, leather making industry, paper manufacturing industry and agricultural implements.

## XII. Estate and stamp duties

New Estate Duty and Stamp Acts will be enacted.

## XIII. Embarkation tax

The embarkation tax (at present 25 Rs.) per passenger will be increased to 100 Rs.

## XIV. Registration fees

Registration fees for vehicles, annual licence fees on diesel driven passenger cars, fees on the issue of a passport, and fees charged on persons granted admission to the airport departure lounge and/or the viewing gallery will be increased.

## XV. Motor vehicles

The tax on transfer of motor vehicles will be reduced to 2,500 Rs.

# Conference Diary

## FEBRUARY 1980

*Business Perspectives:* 6th International Tax Conference (including The Unitary System of Taxing Corporations in the U.S.A.; The Legal and Tax Conditions of Trading with the People's Republic of China; Taxes on Oil, Gas, Shipping and Natural Resources), Singapore, February 3-8 (English).

*Management Centre Europe:* International Tax Management (including Inter-company pricing, licensing, service fees, goods valuation), Brussels (Belgium), February 7-8 (English).

*British Branch of I.F.A.:* The unitary basis of taxation, London (U.K.), February 13 (English).

*Inter-American Center of Tax Administrators (CIAT):* XXII Technical Conference of CIAT on value added sales tax administration, Bogotá (Colombia), February 11-15 (English, Spanish).

*Seminars International:* Foreign investment in the United States (including U.S. taxation of foreign investors), London (United Kingdom), February 19 and 20 (English).

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## MARCH 1980

*Business International Institute:* Seminar on finance; current practices, future trends (including taxation of exchange gains and losses), Zürich (Switzerland), March 3-5 (English).

*Management Centre Europe:* Managing and developing foreign subsidiaries (including tax in international operations), Brussels (Belgium), March 5-7 (English).

*British Branch of I.F.A.:* Exchanges of information and extra territorial claims by Revenue authorities (Tax Workshop), London (U.K.), March 6 (English).

*Münchner Steuerfachtagung:* Munich 1980 Tax Expert Conference (including tax policy and tax administration, international tax law in connection to the relation between German Federal Republic and Canada, Munich (German Federal Republic), March 20 and 21 (German).

*British Branch of I.F.A.:* Estate and gift tax treaties (Tax Workshop), London (U.K.), March 27 (English)

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## MAY 1980

*Anglo-U.S. branches:* Seminar (subject not yet known) New York (U.S.A., May 8 and 9 (English).

*U.S. branch of I.F.A.:* Technical Session (subject not yet known) New York (U.S.A.), May 10 (English).

*International Tax Planning Association:* The Cannes Tax Conference (including exchange of information under tax treaties), Cannes (France), May 28-30 (English).

## SEPTEMBER 1980

*34th Annual Congress of I.F.A.:* I. The dialogue between the tax administration and taxpayer up to the filing of the tax return; II. The determination of the source of income. For the seminar the subject is the flight to tax havens, their use and abuse. Paris (France), September 14-19 (English French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

Business International Institute, 12-14 chemin Rieu, 1211 Geneva 17 (Switzerland).

British Branch of I.F.A.: Secretariat c/o Williams and Glyn's Bank Ltd., 20 Birchin Lane, London EC3P 3DP (United Kingdom).

Business Perspectives, 11 Alexander Place, London SW7 2SG (United Kingdom).

International Fiscal Association (I.F.A.): General Secretariat, Woudenstein, Burg. Oudlaan 50, P.O. Box 1738, 3000 DR Rotterdam (Netherlands).

Investment and Property Studies Ltd., Norwich House, Norwich Street, London EC4A 1AB, United Kingdom (Registration for the Cannes Tax Conference should apply to this address).

Inter-American Center of Tax Administrators (CIAT): Apartado 2129, Panamá 9 A, Panamá.

Management Centre Europe, Avenue des Arts 4, B-1040 Brussels (Belgium).

Münchner Steuerfachtagung e. V. c.o. Lehrstuhl Professor Dr. Klaus Vogel, Ludwigstrasse 28 RG 800 Müchen 22, Bundesrepublik Deutschland.

Seminars International, 1 Falconberg Court, London W1V 5FG, United Kingdom.

## UNITED STATES:

# VAT BEFORE CONGRESS

### I. INTRODUCTION *

The Honorable Al Ullman (D., Oregon), Chairman of the Committee on Ways and Means, U.S. House of Representatives, today announced that he has introduced H.R. 5665, the "Tax Restructuring Act of 1979", a bill that would provide substantial reductions in individual income taxes, corporate income taxes and social security taxes in order to promote economic growth, stability and productivity. In order to preserve fiscal and budgetary discipline, the bill provides that these reductions would be funded by the imposition of a new Federal value added tax (VAT) to be applied at each stage of business activity on an added value basis. The Chairman simultaneously announced public hearings on his bill and on alternative proposals to revitalize the economy and to restructure the Federal tax system, beginning Wednesday, November 7, 1979.

In announcing these hearings, Chairman Ullman stressed that the tax reductions and the value added tax should be viewed as a total package. He emphasized that the package is designed to be revenue neutral, with the new VAT serving as a replacement tax for certain existing revenue sources, not an additional tax. The Chairman stated that witnesses will be expected to state their position and recommendations on the entire package — not just on selected parts of the bill.

The purpose of these hearings is to re-examine the basic Federal tax structure in light of the imperative need to face up to the critical problem of persistently escalating inflation, to encourage capital formation and to increase savings, investment, and productivity in the private sector, and to provide important tax relief for individuals and businesses.

A brief summary of Chairman Ullman's bill is attached to this notice. A more detailed summary will also be available to the Committee office.

The hearings will begin on Wednesday, November 7, 1979, at 10:00 a.m. each day and will be held in Room 1100 Longworth House Office Building, the Main Committee Hearing Room.

The lead-off witness on Wednesday, November 7 will be the Honorable G. William Miller, Secretary of the Treasury, to be followed on Thursday, November 8 by other Administration witnesses and by the Honorable Paul A. Volcker, Chairman of the Federal Reserve Board. On Wednesday, November 14 and Thursday, November 15, the Committee will hear several panels of invited expert witnesses. The Committee will then begin testimony from Members of Congress and the general public who have requested to be heard on Tuesday, November 27.

Please note that these hearings are subject to interruption for conference committee meetings on urgent legislation, such as the oil windfall profits tax.

### II. STATEMENT BY REPRESENTATIVE AL ULLMAN (D., OREGON) UPON INTRODUCTION OF THE "TAX RESTRUCTURING ACT OF 1979", OCTOBER 22, 1979

We all share a deep foreboding that our way of life is eroding; that the ingenuity and the competitive spirit that established America's economic leadership is lagging.

The signs of economic weakness are widely visible. Inflation — our most dreadful enemy — is quietly stealing control of our vital choices. Running higher than 13 percent, it seems all but immune to traditional economic remedies.

We've suffered two significant recessions over the last decade, yet inflation seems to have emerged stronger from each. Sending prime interest rates above 14 percent attacts inflation in some sectors of the economy — at the very real risk of sending the entire country into a prolonged recession. A balanced budget by itself won't solve inflation.

Productivity — the measure of economic efficiency — is declining. Much of the drop is explained by our national fear of spiraling inflation and the race to consume rather than save and invest. Without economic certainty and the incentives to expand, the private sector will continue to lose its technological and competitive edge.

Interest rates are perilously high, and rising. Our trade balance is deep in the red. The reckless price of gold reflects the weakness of the dollar. Public debt is at an all time high, yet is far outdistanced by consumer and corporate debt.

These symptoms of decay — especially inflation — cannot be treated on the surface. They must be fought at the source.

I have come to the conclusion that the only way we can get to the source is to restructure the tax system — now.

In recent years we have improved standards of tax fairness and equity. We have accommodated shifting economic and social demands. But the fundamental structure of the system — heavy reliance on income and payroll taxes — has become muscle bound and unresponsive to recent economic trends.

We don't have to look much beyond the ends of our noses to see that traditional responses — the "quick fix" tax cut, shotgunning tax credits, indexing — no longer carry much punch. By now we've learned that chipping away at the tax code won't solve today's economic troubles.

Income and payroll taxes — forced up by inflation — are discouraging employment and investment. The nation is pushed to spend, rather than save. As confidence in our tax system erodes, so does the tax base.

* Extract of Press Release of October 22, 1979.

## BRIEF SUMMARY OF THE TAX RESTRUCTURING ACT OF 1979

The bill would restructure our tax system to promote investment and productivity growth. Total tax reductions would equal $130 billion on a calendar year 1981 basis. Net proceeds from the value added tax imposed by the bill would also equal $130 billion.

### TAX REDUCTIONS

**Social security—$52 billion.**

A 2.15-percentage point reduction on the employee and the employer rates, with comparable reductions for the self-employed.

**Individual income—$50 billion.**

Rate reductions of $42 billion concentrated on middle income taxpayers.

A 50-percent maximum rate.

Earned income credit increased to a maximum of $750; childless couples made eligible.

Tax credit for elderly made refundable.

Increased AFDC payments.

Special savings accounts into which individuals could contribute $1,000 per year; earnings on account not taxable until withdrawn.

Individual Retirement Account (IRA) limit increased to $2,000 per year.

New Limited Individual Retirement Accounts; $1,000 a year limit for those not qualified for IRA's.

Dividend reinvestment plans for up to $1,500 per year.

**Business income—$28 billion**

Corporate rate cuts; maximum rate reduced to 36 percent; lower bracket rates reduced to 15, 20, 25, and 30 percent, and brackets widened to $40,000 each.

Liberalize depreciation by increasing the Asset Depreciation Range (ADR) variance to 40 percent above and below the ADR class lives; small businesses would be allowed to use ADR lives and the variance without being subject to complicated regulations.

Liberalize the investment tax credit by applying the full credit to assets with lives of five years or more; 60 percent of the full credit would apply to assets with three- and four-years lives.

### VALUE ADDED TAX

The bill would impose the VAT at each stage of the production and distribution process, including the retail stage. The tax would generally be 10 percent of the value of property or services and would be included in the price which a business charges its customers. Each business in the production and distribution chain would receive a credit for the VAT previously paid on its purchases of property and services from other businesses (including purchases of plant and equipment). Thus, each business would pay a net tax equal to 10 percent of the value it adds to the product, and the total tax paid with respect to sales to consumers would be 10 percent of the retail value of the product.

To avoid narrowing the VAT base, special rules or special tax rates have been limited except where considered absolutely essential. Food, medical care, and residential housing would be taxed at only a five-percent rate at the retail level. Transactions of charities, public and private non-profit educational institutions, mass transit, and non-retail sales by farmers and fishermen have been given a zero tax rate, which means there would be no tax but the taxpayer would receive applicable VAT credits. Governments and non-profit organizations other than charities have been exempted from the VAT; they would pay no tax and get no credit. The bill provides special rules for real property, interest transactions, and insurance companies. Also, businesses which have sales of property and services below $10,000 per year could elect to be exempt from the VAT.

The VAT would be imposed on imports. Exports have been zero rated to permit a rebate of VAT previously paid for goods and services associated with the export. This "border tax adjustment" will permit American exporters to compete more effectively with foreign businesses.

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This drift comes at a time when our capital needs for energy products, transportation, environmental quality and research and development have never been greater.

Restructuring the tax system must begin by rolling back social security tax by a third — from 6.65 percent to 4.5 percent. We must cut personal income taxes to counter the impact of inflation. And that includes major expansion of the earned income tax credit for the poor and the retirement tax credit for the elderly.

If business is to survive, let alone prosper, we've got to expand incentives for capital formation. A 10 percentage point cut in the top corporate tax rate (from 46 percent to 36 percent), depreciation reform, reducing the maximum personal tax rate to 50 percent, special treatment of personal savings income, and dividend reinvestment must all be components of a broad tax proposal.

Brought to bear at once, these incentives represent the largest adjustments in U.S. taxation since 1913. Combined, their effect on investment, savings, capital formation, and exports would be massive. These tax cuts amount to $130 billion a year, beginning in 1981.

There are three ways of paying for a plan of this magnitude: cut spending by $130 billion, run up the deficit another $130 billion, or create an alternative source of revenue.

No reasonably informed Amercian believes that spending can be reduced enough to compensate for such enormous tax cuts without creating severe economic and social disruption.

Likewise, to finance these tax changes with additional debt — or the promise of "feedback" — would be political arrogance. Washington has received the taxpayer's message. We understand the national demand for fiscal discipline and a balanced budget.

The remaining option is a replacement tax that raises one dollar for every dollar lost through these tax cuts. In my judgment, the best alternative available — one that would both allow deep tax cuts and directly confront our critical economic imbalance — is a broad-based consumption tax. In short, an Americanized version of the value added tax (VAT).

A value added tax is a novelty in this country. It stirs many prejudices and cliches. But I think the trade off for tax cuts justifies the proposal.

The goal we must keep in focus is the need to shift income from consumption to savings and investment — within the framework of a balanced budget. No painless formula exists. Any new economic course demands short term adjustment — and imbalance. The crucial question that we must address is whether we are willing to make a short term investment for a long term gain.

What is a value added tax?

A value added tax is a tax on consumer goods and services. It is a flat tax — a 10 percent tax — that falls every time the item passes from one firm to another on the way to the final market place. At every step, the tax is collected and sent to the government. Using a system of rebates on taxes paid along the line, the cumulative tax at the retail level cannot exceed 10 percent.

The VAT is not a new tax concept. It is used by most of our competitors in the free world — countries that are surpassing us in economic growth.

Many attack VAT as a "national sales tax". A sales tax is imposed only once — at the retail level. If the final seller does not collect the tax, the revenue is lost. A VAT, by contrast, is collected all along the way. It is more efficient than a sales tax, and, consequently, minimizes economic distortion. But, like all taxes on business, the value added tax is ultimately paid by the consumer.

A tax on consumption would give us an even flow of tax revenue. Today's boom and bust cycles have turned tax receipts into a guessing game. Every time we sink into recession, tax revenues fall off because more workers are out of jobs — and, at the same time, federal spending increases to pay for higher insurance protection. A value added tax would be paid all the time — by all the people. And the effect on economic certainty and stability would be dramatic.

The VAT in my bill is virtually a tax without loopholes. Everyone would pay — including those engaged in the "underground" economy. Those who spend more would pay more. Although those with limited budgets typically would pay proportionally more than those with large incomes, a VAT can be shaped into a fair tax — certainly less regressive than the payroll tax, which nearly everyone now pays.

We have made every effort to lessen the individual burden of the tax. The Americanized VAT would place a lower tax rate — five percent — on vital human necessities like food, housing, and medical costs. Mass transportation, tuition, and charities would pay no net VAT. Income and social security tax reductions will make up much of the lost purchasing power.

We cannot make everyone "whole". The price of combating the real causes of our economic crisis is high. In the long run, the rate of inflation will come down and productivity will climb — and we will share the benefits. In the meantime, we must begin to share the cost of those future benefits.

A VAT would also help improve our trade posture by putting American workers and manufacturers on a more equal footing with our trading partners. Unlike payroll and income taxes the VAT could be rebated to manufacturers when products are exported and could be imposed on imported goods. Such border taxes are now levied in most other free world countries, and help to explain our current unfavorable trade balance.

A VAT would have a one-time inflationary impact. However, retail prices would rise less than 10 percent because of offsetting payroll and income tax cuts — and a strong surge of market competition. And the consumer would also benefit from the same cuts in his own taxes. In the long run, the benefits brought with a value added tax — payroll and income tax cuts, savings and investment incentives — will give us the economic muscle to control inflation and restore productivity growth.

The value added tax is a new approach for most Americans. It will draw sharp debate, as must all new concepts for massive change. But our economy today hangs in the balance. We've got to move this country off dead center. The question ultimately comes down to our willingness to pay the freight charge.

The choices are few. An American value added tax is not the easiest answer — but it is the most realistic.

I trust the bill I introduce today [10-22-79] will intensify national focus on our economic weaknesses — and ultimately lead to a dramatic shift in our tax laws. Only then can we convince the world that America is determined to retain its leadership on the strength of a productive and stable economy.

To that end, I have scheduled full Committee hearings — beginning November 7 — on the full scope of economic trends, their meaning, and what can be done to set a new course in tax policy. It is not my intention to make the value added tax the focal point of these hearings — only a serious option.

## III. VAT — TEXT OF THE LAW AND EXPLANATION

### SEC. 301. IMPOSITION OF TAX.

(a) *In General.* — Subtitle D (relating to miscellaneous excise taxes) is amended by inserting before chapter 31 the following new chapter:

### "CHAPTER 30 — VALUE ADDED TAX

"Subchapter A. Imposition of tax.
"Subchapter B. Taxable transaction.
"Subchapter C. Taxable amount; rate of tax for certain transactions; credit against tax.
"Subchapter D. Administration.
"Subchapter E. Definitions and special rules; treatment of certain transactions.

#### "Subchapter A — Imposition of Tax

"Sec. 4001. Imposition of tax.

#### "SEC. 4001. IMPOSITION OF TAX.

"(a) *General Rule.* — A tax is hereby imposed on each taxable transaction.
"(b) *Amount of Tax.* — Except as other wise provided in this chapter, the amount of tax shall be 10 percent of the taxable amount."

*Explanation 1 — Imposition of value added tax.*
The bill would impose a value added tax (VAT) on sales of property and services at each stage of the production and distribution process, including the retail stage. The tax would generally be 10 percent of the value of property or services sold and would be included in the price which a business charges its customers. Each business in the production and distribution chain would receive a credit for the VAT previously paid by it on purchases of property and services from other businesses. Thus, businesses would generally pay a net tax equal to 10 percent of the value they add to products and services sold. The total tax paid with respect to a sale to a consumer would be 10 percent of the retail value of the property or services.

#### "Subchapter B — Taxable Transaction

"Sec. 4003. Taxable transaction.
"Sec. 4004. Commercial-type transaction.
"Sec. 4005. Taxable person.
"Sec. 4006. Transactions in the United States.
"Sec. 4007. Rules relating to other terms used in section 4003.

## "SEC. 4003. TAXABLE TRANSACTION.

"For purposes of this chapter, the term "taxable transaction" means —
"(1) the sale of property in the United States,
"(2) the performance of services in the United States, and
"(3) the importing of property into the United States,
by a taxable person in a commercial-type transaction.

## "SEC. 4004. COMMERCIAL-TYPE TRANSACTION.

"*(a) General Rule.* — For purposes of this chapter, the term "commercial-type transaction" means a transaction engaged in by —
"(1) a corporation, or
"(2) any person (other than a corporation) in connection with a business.

"*(b) Sales and Leases of Real Property; Imports.* — For purposes of this chapter —
"*(1) In general.* — The term "commercial-type transaction" includes —
"(A) any sale or leasing of real property, and
"(B) any importing of property,
whether or not such transaction is described in subsection (a).
"*(2) Certain imported articles.* — Notwithstanding paragraph (1)(B), the importing of an article which is free of duty under part 2 of schedule 8 of the Tariff Schedules of the United States shall not be treated as a commercial-type transaction unless such transaction is described in subsection (a).

## "SEC. 4005. TAXABLE PERSON.

"*(a) General Rule.* — Except as otherwise provided in this chapter, for purposes of this chapter, the term "taxable person" means a person who engages in a business or in a commercial-type transaction.

"*(b) Treatment of Employees, Etc.* — For purposes of this chapter, an employee shall not be treated as a taxable person with respect to activities engaged in as an employee.

## "SEC. 4006. TRANSACTIONS IN THE UNITED STATES.

"*(a) Sales of Property.* — For purposes of this chapter —
"*(1) In general.* — Except as provided in paragraph (2), the sale of property shall be treated as occurring where delivery takes place.
"*(2) Real Property.* — The sale of real property shall be treated as occurring where the real property is located.

"*(b) Performance of Service.* — For purposes of this chapter —
"*(1) In general.* — Except as otherwise provided in this subsection, a service shall be treated as occurring where it is performed.
"*(2) Services performed inside and outside United States.* — If a service is performed both inside and outside the United States, such service shall be treated as performed —
"(A) inside the United States, if 50 percent or more of such service is performed inside the United States, and
"(B) outside the United States, if less than 50 percent of such service is performed inside the United States.

## "SEC. 4007. RULES RELATING TO OTHER TERMS USED IN SECTION 4003.

"*(a) Exchanges Treated as Sales.* — For purposes of this chapter —
"(1) an exchange of property for property or services shall be treated as a sale of property, and
"(2) an exchange of services for property or services shall be treated as the performance of services.

"*(b) Certain Transfers to Employees Treated as Sales.* — For purposes of this chapter, the transfer of property to an employee as compensation (other than a transfer of a type for which no amount is includible in the gross income of employees for purposes of chapter 1) shall be treated as the sale of property.

"*(c) Performance of Services.* — For purposes of this chapter —
"*(1) Certain activities treated as performance of services.* — Activities treated as included in the performance of services shall include (but shall not be limited to) —
"(A) permitting the use of property,
"(B) the granting of a right to the performance of services or to reimbursement (including the granting of warranties, insurance, and similar items), and
"(C) the making of a covenant not to compete (or similar agreement to refrain from doing something).
"*(2) Employers and employees.* —
"(A) Services for employer. — An employee's services for his employer shall not be treated as the performance of services.
"(B) Services for employee. — An employer's services for his employee shall not be treated as the performance of services unless such services are of a type which constitute gross income to the employee for the purposes of chapter 1.
"*(3) Performance of services treated as sale of services.* — The performance of services shall be treated as the sale of services."

*Explanation 2 — Taxable transaction.*
The bill would define "taxable transaction" as the sale of property in the United States, the performance of a service in the United States, and the importing of property into the United States by a taxable person in a commercial-type transaction.

The term "sale of property" would not be restricted to the sale of property in the usual sense. It would also include (1) the exchange of property, (2) the transfer of property to an employee as compensation, (3) the permanent transfer of business property to an owner of the business, (4) gifts of business property, and (5) certain transactions of governments and tax-exempt organizations.

The term "performance of services" would include certain transactions in addition to the performance of personal services for a fee. These other transactions would include (1) permitting the use of property, (2) the exchange of services, (3) the granting of a right to the performance of services or to reimbursement (including the granting of warranties, insurance, and similar items), (4) the making of a covenant not to compete or a similar agreement, (5) the use of business property or services by an owner of the business, (6) gifts of business services, and (7) certain transactions of governments and tax-exempt organizations. However, the "performance of services" would not include an employee's performance of services for his employer.

Under the bill, "commercial-type transactions" would mean a transaction engaged in by a corporation (other than a subchapter S corporation) or by any person engaged in a business. The sale or leasing of real property and the importing of property would also be treated as a commercial-type transaction and would be subject to the VAT, even if engaged in by a consumer and not by a corporation or a person engaged in a business. Importing of articles by a consumer which would be free of duty under the personal exemptions under the United States Tariff Schedules would not be subject to the VAT.

The bill would define "taxable person" as a person engaged in a business or in a commercial-type transaction. Business would include a trade as well as an activity regularly carried on for profit. Governments and tax-exempt organizations would also be taxable persons in certain circumstances.

Under the bill, the sale of property would generally be treated as occurring in the United States if delivery of the property takes place in the United States. In the case of real property, the sale would be deemed to occur where the real property is located.

Services would be treated as occurring where the services are performed. If services are performed both inside and outside the United States, the services would be deemed performed entirely inside the United States if 50 percent or more of the services are performed in the United States. Otherwise, the services would be treated as performed entirely outside the United States.

The bill would define "property to mean any tangible property.

### "Subchapter C – Taxable Amount; Rate of Tax for Certain Transactions; Credit against Tax

"Sec. 4011. Taxable amount.
"Sec. 4012. 5-percent rate of tax for food, housing, and medical care.
"Sec. 4013. Zero rating for farmers, fishermen, mass transit, section 501(c)(3) organizations, the educational activities of governmental entities, exports, and interest.
"Sec. 4014. Credit against tax.

### "SEC. 4011. TAXABLE AMOUNT.

"*(a) Amount Charged Customer.* — For purposes of this chapter, the taxable amount for any transaction for which money is the only consideration shall be the price charged the purchaser of the property or services by the seller thereof —

"(1) including all invoiced charges for transportation, and other items payable to the seller with respect to this transaction, but

"(2) excluding the tax imposed by section 4001 with respect to this transaction and excluding any State and local sales and use taxes with respect to this transaction.

"*(b) Exchanges.* — For purposes of this chapter, the taxable amount in any exchange of property or services shall be the fair market value of the property or services transferred by the person liable for the tax (determined as if such person had sold the property or services to the other party to the exchange).

"*(c) Imports.* — The purposes of this chapter, the taxable amount in the case of any import shall be —

"(1) the customs value plus customs duties and any other duties which may be imposed, or

"(2) if there is no such customs value, the fair market value (determined as if the importer had sold the property).

"*(d) Special Rule in the Case of Sales of Certain Used Consumer Goods.* —For purposes of this chapter, if —

"(1) a taxable person acquires any tangible personal property in a transaction which was not a taxable transaction,.and

"(2) Such property had been used by an ultimate consumer before such acquisition,

the taxable amount in the case of any sale of such property by such taxable person (determined without regard to this subsection) shall be reduced by the amount paid for such property by such taxable person."

*Explanation 3 — Taxable amount.*

Generally, the taxable amount on which the VAT would be imposed would be the price charged for property or services. This would include charges for transportation and other items payable to the seller. The taxable amount would not, however, include any interest or carrying charges. In an exchange of property or services, the taxable amount would be the fair market value of the property or services exchanged by the taxable person (determined as if the taxable person had sold the property or services to the other party to the exchange).

In the case of imports, the bill provides that the taxable amount would generally be the customs value plus customs and any other duties which may be imposed. If there is no customs value, the taxable amount would be the fair market value of the property.

The bill provides a special rule for the determination of the taxable amount in the case of certain used consumer goods. When a taxable person acquires used property from a consumer for resale, the taxable amount on the resale would be the difference between the selling price and the taxable person's acquisition cost of the used property.

### "SEC. 4012. 5-PERCENT RATE OF TAX FOR FOOD, HOUSING AND MEDICAL CARE.

"*(a) 5-Percent Rate for Food, Housing, and Medical Care.* — The rate of the tax imposed by section 4001 shall be 5 percent with respect to the following:

"*(1) Food.* — The retail sale of food and non-alcoholic beverages for human consumption.

"*(2) Housing.* — The sale and renting of residential real property for use by the purchaser or tenant as a principal residence.

"*(3) Medical care.* — Medical care.

"*(b) Definitions.* — For the purposes of subsection (a) —

"*(1) Non-alcoholic beverages.* — The term "non-alcoholic beverages" does not include any article which is taxable under chapter 51.

"*(2) Medical care.* — The term "medical care" means the performance of any service, and the retail sale of any property, payment for which by the purchaser would constitute medical care within the meaning of section 213.

"*(3) Mobile homes, etc., treated as real property.* — A mobile or floating home shall be treated as real property."

*Explanation 4 — Five-percent rate of tax for food, housing and medical care.*

Under the bill, a five-percent rate of VAT, rather than the standard 10-percent rate, would be imposed on (1) the retail sale of food and non-alcoholic beverages for human consumption, (2) the sale and rental of residential real property for use by the purchaser or tenant as a principal residence, and (3) medical care.

### "SEC. 4013. ZERO RATING FOR FARMERS, FISHERMEN, MASS TRANSIT, SECTION 501 (c)(3) ORGANIZATIONS, THE EDUCATIONAL ACTIVITIES OF GOVERNMENTAL ENTITIES, EXPORTS, AND INTEREST.

"The rate of the tax imposed by section 4001 shall be zero with respect to the following:

"*(1) Sales by farmers or fishermen.* — The sale (other than at retail) of —

"(A) agricultural commodities by the producer of such commodities, or

"(B) fish (or any other form of aquatic animal life) by a person in whose business such fish (or other forms) were caught.

"*(2) Mass transit.* — The performance of mass transportation services in urbanized areas.

"*(3) Section 501 (c)(3) organizations.* — Any taxable transaction engaged in by a section 501 (c)(3) organization other than as part of an unrelated business.

"*(4) Educational activities of governmental entity.* — The providing by a governmental entity of property and services in connection with the education of students.

"*(5) Exports.* — Exports of property.

"*(6) Interest.* — Interest."

*Explanation 5 — Zero rating for farmers and fishermen, mass transit, section 501 (c)(3) organizations, educational activities of governmental entities, exports, and interest.*

Under the bill, the rate of tax which would be imposed on certain transactions would be zero. Thus, no tax would be imposed on (1) non-retail sales of farmers and fishermen, (2) mass transit in urbanized areas, (3) transactions engaged in by an organization described in section 501 (c)(3) of the Code other than as part of an unrelated business, (4) educational activities of governmental entities, (5) exports, and (6) interest.

**"SEC. 4014. CREDIT AGAINST TAX.**

"*(a) General Rule.* — There shall be allowed as a credit against the the tax imposed by section 4001 the aggregate amount of tax imposed by section 4001 which has been paid by sellers to the taxpayer of property and services which the taxpayer uses in the business to which the transaction relates.

"*(b) Exempt Transactions, Etc.* — if —

"(1) property or services are used partly in the business and partly for other purposes, or

"(2) property or services are used partly for taxable transactions and partly for other transactions,

the credit shall be allowable only with respect to the property and services used for taxable transactions in the business. No credit shall be allowable for any transaction occurring when the taxpayer was a non-taxable person.

"*(c) Excess Credit Treated as Overpayment.* —

"*(1) In general.* — If for any taxable period the aggregate amount of the credits allowable by subsection (a) exceeds the aggregate amount of the tax imposed by section 4001 for such period, such excess shall be treated as an overpayment of the tax imposed by section 4001.

"*(2) Time when overpayment arises.* — Any overpayment under paragraph (1) for any taxable period shall be treated as arising on the later of —

"(A) the due date for the return for such period, or

"(B) the date on which the return is filed."

*Explanation 6 — Credit against VAT.*
A taxable person would generally be permitted to take a credit (VAT credit) for the VAT paid by its suppliers on its purchases of property and services. The VAT credit would be allowable only with respect to property and services used for taxable transactions in the business. If such property or services are used partly in the business and partly for other purposes or partly for taxable transactions and partly for other transactions, the amount of VAT credit which could be taken would have to be determined on the basis of an allocation.

The VAT credit would first be applied to reduce the VAT liability for a taxable period. If the amount of the credit exceeds the amount of tax for the taxable period, the excess would be treated as an overpayment of tax and would be refundable.

**"Subchapter D — Administration**

"Sec. 4021. Seller liable for tax.
"Sec. 4022. Tax invoices.
"Sec. 4023. Small business exemption.
"Sec. 4024. Time for filing return and claiming credit; deposits of tax.
"Sec. 4025. Treatment of related businesses, etc.
"Sec. 4026. Value added tax not separately stated.
"Sec. 4027. Secretary to be notified of certain events.
"Sec. 4028. Regulations.

**"SEC. 4021. SELLER LIABLE FOR TAX.**

"The person selling the property or services shall be liable for the tax imposed by section 4001.

**"SEC. 4022. TAX INVOICES.**

"*(a) Seller Must Give Purchaser Tax Invoice.* — Any taxable person engaging in a taxable transaction shall give the purchaser a tax invoice with respect to such transaction if the seller has reason to believe that the purchaser is a taxable person.

"*(b) Content of Invoice.* — The tax invoice required by subsection (a) with respect to any transaction shall set forth —

"(1) the name and identification number of the seller,

"(2) the name of the purchaser,

"(3) the amount of the tax imposed by section 4001, and

"(4) such other information as may be prescribed by regulations.

"*(c) No Credit Without Invoice.* —

"*(1) In general.* — Except as provided in paragraphs (2) and (3), a purchaser may claim a credit with respect to a transaction only if the purchaser —

"(A) has received from the seller and has in his possession a tax invoice which meets the requirements of subsection (b), and

"(B) is named as the purchaser in such invoice.

"*(2) Employees or other agents named in invoices.* — To the extent provided in regulations, the naming of an employee or other agent of the purchaser shall be treated as the naming of the purchaser.

"*(3) Waiver of invoice requirement in certain cases.* — To the extent provided in regulations, paragraph (1) shall not apply —

"(A) where the purchaser without fault on his part fails to receive or fails to have in his possession a tax invoice,

"(B) to a taxable transaction (or category of transactions) where —

"(i) the amount involved is de minimis, or

"(ii) the information required by subsection (b) can be reliably established by sampling or by another method and can be adequately documented.

"*(d) Time for Furnishing Invoice.* — Any invoice required to be furnished by subsection (a) with respect to any transaction shall be furnished not later than 15 business days after the tax point for such transaction.

**"SEC. 4023. SMALL BUSINESS EXEMPTION.**

"*(a) In General.* — Under regulations, a person —

"(1) whose aggregate taxable transactions for the calendar year do not exceed \$10,000, and

"(2) whose aggregate taxable transactions for the next calendar year can reasonably be expected not to exceed \$10,000,

may elect to be treated as a person who is not a taxable person for the next calendar year.

"*(b) Exceptions.* — Subsection (a) shall not apply —

"(1) to any sale or leasing of real property, and

"(2) to any importing of property.

"*(c) Termination of Election.* — Any election under subsection (a) for a calendar year shall terminate if the aggregate taxable transactions —

"(1) for the first calendar quarter in such year exceed \$3,500,

"(2) for the first 2 calendar quarters in such year exceed \$6,000, or

"(3) for the first 3 calendar quarters in such year exceed \$8,500.

Such termination shall take effect on the first day of the second month following the close of the first period in which the requirements of paragraph (1), (2), or (3) are met.

"*(d) Taxable Amount Treated as Zero for Zero-Rated Transactions.* — For purposes of this section, the taxable amount of any zero-rated transaction shall be treated as zero.

"*(e) Condition of Election.* — In the case of a person who is a taxable person for any period, an election under subsection (a) may be made for succeeding periods only with the consent of the Secretary. Such consent shall be conditioned on placing such person, for all succeeding periods, in the same position with respect to the tax imposed by section 4001 (and the credit allowed by section 4014) he would have been in if all property and services he holds at the time he becomes a non-taxable person had been acquired as a non-taxable person.

"*(f) Casual Sales and Leases of Real Property Excluded.* — For purposes of this section, the term "taxable transaction" does not include a transaction which is treated as a commercial-type transaction solely by reason of section 4004 (b)(1)(A).

### "SEC. 4024. TIME FOR FILING RETURN AND CLAIMING CREDIT; DEPOSITS OF TAX.

"*(a) Filing Returns.* — Before the first day of the second calendar month beginning after the close of each taxable period, each taxable person shall file a return of the tax imposed by section 4001 on taxable transactions having a tax point within such taxable period.

"*(b) Credit Allowed for Taxable Period in which Purchaser Receives Invoice.* —

"*(1) In general.* — Except as provided in paragraph (2), a credit allowable by section 4014 with respect to a transaction may be allowed only for the first taxable period by the close of which the taxpayer —

"(A) has paid or accrued amounts properly allocable to the tax imposed by section 4001 with respect to such transaction, and

"(B) has a tax invoice (or equivalent) with respect to such transaction.

"*(2) Use for later period.* — Under regulations, a credit allowable by section 4014 may be allowed for a period after the period set forth in paragraph (1).

"*(c) Taxable Period.* — For purposes of this chapter —

"*(1) In general.* — The term "taxable period" means a calendar quarter.

"*(2) Exception.* —

"(A) Election of 1-month period. — If the taxpayer so elects, the term "taxable period" means a calendar month.

"(B) Other periods. — To the extent provided in regulations, the term "taxable period" includes a period, other than a calendar quarter or month, selected by the taxpayer.

"*(d) Tax Point.* — For purposes of this chapter —

"*(1) Chapter 1 rules with respect to seller govern.* — Except as provided in paragraph (2), the tax point for any sale of property or services is the earlier of —

"(A) the time (or times) when any income from the sale should be treated by the seller as received or accrued (or any loss should be taken into account by the seller) for purposes of chapter 1, or

"(B) the time (or times) when the seller receives payment for the sale.

"*(2) Imports.* — In the case of the importing of property, the tax point is when the property is entered, or withdrawn from warehouse, for consumption in the United States.

"*(e) Monthly Deposits Required.* — To the extent provided in regulations, monthly deposits may be required of the estimated liability for any taxable period for the tax imposed by section 4001.

### SEC. 4025. TREATMENT OF RELATED BUSINESSES, ETC.

"*(a) General Rule.* — For purposes of this chapter (other than section 4023), to the extent provided in regulations, the taxpayer may elect —

"(1) to treat as 1 taxable person 2 or more businesses which may be treated under section 52(b) as 1 employer, and

"(2) to treat as separate taxable persons separate divisions of the same business.

"*(b) Small Business Exemption.* — For the purposes of section 4023, all businesses which are under common control (within the meaning of section 52(b) shall be treated as 1 business.

### "SEC. 4026. VALUE ADDED TAX NOT SEPARATELY STATED.

"If —

"(1) property or services are sold to an ultimate consumer, and

"(2) the seller has reason to believe that the purchaser is not a taxable person,

the sales ticket or other similar document shall not separately state the amount of the tax imposed with respect to such sale under this chapter.

### "SEC. 4027. SECRETARY TO BE NOTIFIED OF CERTAIN EVENTS.

"To the extent provided in regulations, each person engaged in a business shall notify the Secretary (at such time or times as may be prescribed by such regulations) of any change in the form in which a business is conducted or any other change which might affect the liability for the tax imposed by section 4001 or the amount of such tax or any credit against such tax, or otherwise affect the administration of such tax in the case of such person.

### "SEC. 4028. REGULATIONS.

"The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this chapter."

*Explanation 7 — Administrative provisions. a. Liability for VAT and invoicing.*

Under the bill, liability for the VAT would be imposed on the seller of property or services. In addition to paying the VAT, the seller would be required to provide a tax invoice (setting forth the amount of VAT imposed on the sale and certain other information) to the purchaser if the seller has reason to believe that the purchaser is a taxable person. The invoice would have to be furnished no later than 15 business days after the "tax point."

Generally, a purchaser would not be allowed to claim a VAT credit with respect to a transaction unless it has received a tax invoice in which it is named as a purchaser.

*b. Small business exemption.*

The bill would permit certain businesses, the aggregate taxable transactions of which are and are expected to continue to be below a certain level, to elect not to be treated as a taxable person except with respect to imports and housing. If the election is made by the small business, no tax would be collected on its sales and no credit would be permitted for VAT paid on its purchases. In addition, a recapture of previously allowed credit would be required on property held by the business at the time of the election.

A person could elect to be exempt under the bill's provisions if its taxable transactions do not exceed $10,000 for a calendar year and can reasonably be expected not to exceed $10,000 for the next calendar year. The election, however, would terminate on the first day of the second month following any calendar quarter in that next year if the following has occurred:

(1) aggregate taxable transactions for the calendar quarter exceed $3,500, in the case of the first calendar quarter; or
(2) aggregate taxable transactions for the first two calendar quarters exceed $6,000, in the case of the second calandar quarter; or
(3) aggregate taxable transactions for the first three calandar quarters exceed $8,500, in the case of the third calendar quarter.

*c. Time for filing return and claiming credit.*

The bill would require a taxable person to file a VAT return during the first month following the close of each taxable period. A taxable period for this purpose would generally be a calendar month.

The return would reflect the VAT due on taxable transactions with a "tax point" in the period as well as the VAT credit allowed for the period. When the VAT due exceeds the VAT credit, payment of the difference would accompany the return. If the VAT credit exceeds the VAT due, the excess would be treated as an overpayment of VAT, and the return would be treated as a claim for a refund.

The term "tax point" would be used to describe when a taxable transaction takes place for purposes of the requirement that a taxable person furnish a tax invoice. For a sale of property or services, the determination of the tax point would depend on whether the taxable person keeps its books on the cash basis or on the accrual basis for Federal income tax purposes. In the case of a cash basis taxpayer, the tax point would be the date the taxable person receives payment for the sale. In the case of an accrual basis taxpayer, the tax point would be the earlier of the date the taxable person (1) should accrue income or loss with respect to the sale, or (2) receives payment for the sale. For an importation, the tax point would be the date the imported property is entered for consumption in the United States.

A VAT credit with respect to a purchase transaction would be allowed for a taxable period only if certain conditions were met. The taxable person would be required to have (1) paid or accrued (depending on its method of accounting for Federal income tax purposes) the VAT as part of the purchase price, and (2) received a tax invoice from the seller with respect to the transaction. The VAT credit would generally be allowed for the first taxable period in which both of these conditions were satisfied.

*d. Treatment of related businesses, etc.*
The bill would allow a taxable person to elect to treat itself and all related businesses as one taxable person for VAT purposes. A related business would encompass any business under common control with the taxable person under the more than 50-percent control test described in section 52(b) of the Code. However, for purposes of applying the small business exemption, all businesses under common control would be treated as one business.

The bill would also allow a taxable person to elect to treat any of its divisions as a separate taxable person.

*e. Treasury notification and regulations.*
The bill would require a taxable person to notify the Internal Revenue Service if certain events occurred. These reportable events would be developed by regulations and would encompass a change in the form of a business, or any other change which could affect VAT liability, VAT credit, or VAT administration with respect to the business.

The bill would also give the Secretary of the Treasury broad authority to write regulations with respect to the VAT.

**"Subchapter E – Definitions and Special Rules; Treatment of Certain Transactions**

"Sec. 4031. Definitions.
"Sec. 4032. Special rules.
"Sec. 4033. Personal use by owner of business property or services.
"Sec. 4034. Gift of business property or services.
"Sec. 4035. Special rules for dispositions of non-business real property.
"Sec. 4036. Special rule for insurance contracts.
"Sec. 4037. Governmental entities; exempt organizations.

### "SEC. 4031. DEFINITIONS.

"*(a) Property.* — For purposes of this chapter, the term "property" means any tangible property.

"*(b) Business.* — For purposes of this chapter, the term "business" includes —
"(1) a trade, and
"(2) an activity regularly carried on for profit.

"*(c) Employee.* — For purposes of this chapter, the term "employee" has the meaning such term has for purposes of chapter 24 (relating to withholding).

"*(d) Person.* — For purposes of this chapter, the term "person" includes any governmental entity.

"*(e) Business Day.* — For purposes of this chapter, the term "business day" means any day other than Saturday and Sunday and other than a legal holiday (within the meaning of section 7503).

"*(f) United States.* — For purposes of this chapter, the term "United States" when used in a geographical sense, includes a Commonwealth and any possession of the United States.

### "SEC. 4032. SPECIAL RULES.

"*(a) Coordination with Subtitle A.* — For purposes of subtitle A —
"*(1) Treatment of credit.* — Any credit allowable to a taxpayer under section 4014 which is attributable to any property or services shall be treated as a reduction in the amount paid or incurred by the taxpayer for such property or services.
"*(2) Amount of deduction for tax.* — The amount allowable as a deduction for the tax imposed by section 4001 shall be determined without regard to any credit allowable under section 4014.
"*(3) Computation of percentage depletion.* — For purposes of sections 613 and 613A —
"(A) gross income shall be reduced by the amount of the tax imposed by section 4001, and
"(B) taxable income shall be determined without regard to any deduction allowed for such tax.

"*(b) Special Rule Where Sale of Property Includes Incidental Performance of Services.* — For purposes of this chapter, if in connection with the sale of any property there is an incidental performance of services, such performance of services shall be treated as part of the sale of such property.

"*(c) Special Rule Where Performance of Services Includes Incidental Transfer of Property.* — For purposes of this chapter, if in connection with the performance of any services there is an incidental transfer of property, such transfer shall be treated as part of the performance of such services.

"*(d) Authority to Zero Rate De Minimis Transactions, Etc.* — The Secretary may prescribe regulations providing that the rate of tax shall be zero for a taxable transaction (or category of such transactions) where —
"(1) the amount involved is de minimis, or
"(2) the revenue raised by taxing the transaction is not sufficient to justify the administrative and other costs involved in the payment and collection of the tax.

"*(e) Importing Treated as Sale and Purchase.* — For purposes of this chapter, the importing of any property into the United States shall be treated as both a sale and purchase of such property by the person importing such property.

"*(f) Subchapter S Corporation Treated as Not a Corporation.* — For purposes of this chapter, an electing small business corporation (as defined in section 1371(b)) shall be treated as a person which is not a corporation.

"*(g) Use Includes Held for Use.* — For purposes of this chapter, property and services held for use by any person shall be treated as used by the person.

### "SEC. 4033. PERSONAL USE BY OWNER OF BUSINESS PROPERTY OR SERVICES.

"*(a) General Rule.* — If any business property or services are used by an owner of the taxpayer for personal purposes, for purposes of this chapter such use shall be treated as a taxable transaction.

"*(b) Taxable Amount.* — In the case of a use described in subsection (a), for purposes of this chapter, the taxable amount shall be —
"(1) except as provided in paragraph (2), the fair market value of the property or the services, or
"(2) if such use is only the temporary use of property, the fair rental value of such use.

"*(c) Definitions.* — For purposes of this section —

"*(1) Business property or services.* — The term "business property or services" means any property or services if a sale of such property, or the performance of such services, by the taxpayer would be a taxable transaction.

"*(2) Owner.* — The term "owner" means —

"(A) in the case of a sole proprietorship, the proprietor,

"(B) in the case of any other business enterprise, any holder of a beneficial interest in the corporation, partnership, or other entity, and

"(C) any member of the family (within the meaning of section 267(c) (4)) of an individual described in subparagraph (A) or (B).

### "SEC. 4034. GIFT OF BUSINESS PROPERTY OR SERVICES.

"*(a) General Rule.* — In the case of any gift of business property or services, for purposes of this chapter —

"(1) such gift shall be treated as a taxable transaction, and

"(2) the taxable amount shall be the amount determined under section 4033(b).

"*(b) Gifts Related to Business Promotion Activities.* — For purposes of subsection (a), the term "gift" includes any gift of property or services transferred in connection with business promotion activities.

### "SEC. 4035. SPECIAL RULES FOR DISPOSITIONS OF NON-BUSINESS REAL PROPERTY.

"*(a) In General.* — In the case of any sale of real property which is treated as a commercial-type transaction solely by reason of section 4004(b) (1) (A), for purposes of this chapter, the taxable amount shall be the excess (if any) of —

"(1) the amount realized on such sale, over

"(2) the adjusted cost to the taxpayer of such real property.

"*(b) Adjusted Cost.* — For purposes of subsection (a) —

"*(1) In general.* — Except as provided in paragraph (2), the term "adjusted cost" means, with respect to any property, the basis of such property increased by expenditures properly chargeable to capital account (other than taxes or other carrying charges described in section 266) for periods during the holding period for such property.

"*(2) Transitional rule.* — The adjusted cost of any property shall include only amounts incurred during periods after December 31, 1980.

"*(c) Value Added Tax Not Taken Into Account.* — For purposes of this section, the amount realized on any sale of real property shall not include any amount attributable to the tax imposed by this chapter.

### "SEC. 4036. SPECIAL RULE FOR INSURANCE CONTRACTS

"In the case of any contract of insurance, for purposes of this chapter, the taxable amount is the excess of —

"(1) the portion of the premium attributable to insurance coverage, over

"(2) the actuarial cost to the insurer of providing such insurance coverage.

### "SEC. 4037. GOVERNMENTAL ENTITIES; EXEMPT ORGANIZATIONS.

"*(a) Taxable Transactions for Governmental Entities Only Where Separate Charge Is Made.* — For purposes of this chapter, the sale of property and the performance of services by a governmental entity shall be a taxable transaction if (and only if) a separate charge or fee is made therefor.

"*(b) Section 501 (c)(3) Organizations.* — For purposes of this chapter, a section 501 (c)(3) organization shall be treated as engaged in a business with respect to all of its activities.

"*(c) Other Exempt Organizations.* — For purposes of this chapter, the sale of property and the performance of services by any exempt organization other than a section (501 (c)(3) organization shall be a taxable transaction if (and only if) a charge or fee is made for such services.

"*(d) Definitions.* — For purposes of this chapter —

"*(1) Governmental entity.* — The term "governmental entity" means the United States, any State or political subdivision thereof, the District of Columbia, a Commonwealth or possession of the United States, or any agency or instrumentality of any of the foregoing.

"*(2) Section 501 (c)(3) organization.* — The term "section 501 (c)(3) organization" means an organization described in section 501 (c)(3) which is exempt from tax under section 501 (a).

"*(3) Other exempt organization.* — The term "other exempt organization" means any organization (other than a section 501 (c)(3) organization) which is exempt from tax under chapter 1."

*(b) Clerical Amendment.* — The table of chapters for subtitle D is amended by inserting before the item relating to chapter 31 the following:

"Chapter 30. Value added tax."

### SEC. 302. EFFECTIVE DATE FOR TITLE III.

The amendments made by section 301 shall apply to transactions occurring after December 31, 1980.

*Explanation 8—Special rules and treatment of certain transactions.*

a. *Coordination with income tax rules.*

Under the bill, a taxable person's basis in property for Federal income tax purposes would not include the portion of the purchase price of the property which represents creditable VAT.

b. *Sale of property and incidental services; sale of services and incidental property.*

Under the bill, a sale of property together with incidental related services would be treated as a single transaction constituting a sale of property, rather than as separate sales of property and services. Also, a sale of services together with an incidental transfer of property would be treated as a single transaction constituting a sale of services, rather than as separate sales of services and property.

c. *Authority to zero rate de minimis transactions.*

The bill would provide that, under regulations, an otherwise taxable transaction would be zero rated if (1) the amount involved is negligible, or (2) the VAT revenue from taxing that type of transaction would not be sufficient to justify resulting administrative and compliance costs.

d. *Importing.*

Under the bill, the importer of property would be treated as both the seller and purchaser of the property at the point of importation. Thus, the importer would be both liable for VAT and eligible for a VAT credit with respect to the import.

e. *Subchapter S corporation not treated as a corporation.*

Under the bill, a subchapter S corporation (Code sec. 1371(b)) would not be treated as a corporation for VAT purposes. Accordingly, it would not automatically be considered engaged in business. Thus, as in the case of a non-corporate entity, the determination of whether it is engaged in business and is hence a taxable person would have to made on the basis of relevant facts and circumstances.

f. *Personal use by owner of business property or services.*

Under the bill, the use of business property or services by an owner of a business would be treated as a taxable transaction. In the case of services or a permanent use of property, the amount subject to tax would be the fair market value of the services or property. In the case of a temporary use of property, the amount subject to tax would be the fair rental value of the property. Property or services are considered business property or services if their sale by the taxable person would be a taxable transaction. Under the bill an owner of a business generally means a sole proprietor, partner, or shareholder, as well as certain related family members determined under Code section 267(c)(4).

*g. Gift of business property or services.*
Under the bill, a gift by a business of any business property or services would be treated as a taxable transaction. The taxable amount in the case of such a gift would generally be fair market value. However, where the gift permits the temporary use of business property, the taxable amount would be the fair rental value of the property.

*h. Special rule for dispositions of non-business real property.*
Under the bill, where real property is sold by a person who is not otherwise a taxable person, the person would become taxable with respect to the sale. However, in contrast to most sales transactions, the VAT would not be imposed on the selling price, but would be imposed only on the excess of the selling price over the seller's adjusted cost for the property. For this purpose, the selling price would be calculated exclusive of VAT. The seller's adjusted cost would be his basis in the property increased by certain expenditures properly chargeable to capital account. However, the seller's adjusted cost would not include basis or expenditures due to amounts incurred in periods before January 1, 1981.

*i. Special rule for insurance contracts.*
Under the bill, sales of insurance would be subject to the VAT. The value added of an insuror is represented by the excess of premiums collected over claims paid. Thus, the VAT would not be imposed on premiums at the rate of 10 percent because this would result in taxing an insuror on an amount greater than its value added. In addition, amounts representing savings should not be taxed because the VAT is designed to tax consumption. Accordingly, the bill would impose the VAT only on the difference between the portion of a premium attributable to insurance coverage and the actuarial cost of the coverage.

*j. Taxable transactions for governmental entities; exempt organizations.*
The bill would generally exempt governmental entities from the application of the VAT. An exception would be made for sales by governments for which separate charges are made. Such charges would be subject to the VAT. In the case of charges for education, however, the rate of tax would be zero. Governments would be permitted a VAT credit only on purchases relating to taxable sales, including zero-rated sales.

Charities described in section 501(c)(3) of the Code would be zero rated for all of their sales, except those engaged in as part of an unrelated trade or business (Code sec. 513). Thus, they would be eligible for the VAT credit on their purchases.

Under the bill an exempt organization not described in section 501(c)(3) of the Code would generally be exempt from the application of the VAT. However, sales by such organizations would be taxable if made for a charge. The organizations would be permitted a VAT credit only on purchases relating to taxable sales.

# TAX GLOSSARY

*by H.W.T. PEPPER**

**PERIODICITY OF PAYMENTS** — Since a government's expenditure accrues throughout the fiscal year it is important to secure a steady inflow of taxes and other revenue through the year. Accordingly sales taxes, including V.A.T,, are often collected monthly from the larger taxpayers, income taxes deducted at source, e.g., P.A.Y.E. deductions from employees, and payroll taxes are usually remitted monthly. In the U.K. ADVANCE CORPORATION TAX (q.v.) is paid over quarterly, and in the U.S.A. income tax is payable quarterly by the larger individual taxpayers and corporations. In general it is desirable that taxes be paid as soon as they become due, and particularly in the case of withholding taxes it is desirable that the withholder hand them over as soon as possible.

**PERMANENT ESTABLISHMENT** — A term mainly to be found in double taxation treaties, where it is customarily provided that a business in one country will not be liable to the income tax of the other country, unless it has a "permanent establishment" through which it conducts business *in* that other country. A permanent establishment is usually defined as a place of management, a branch, an office, a factory, a workshop, a mine, quarry or other place of extraction of natural resources, or a building site or assembly project which exists for more than a certain period (6 or 12 months). The definition usually excludes the use of facilities solely for purposes of storage, display, or delivery of goods belonging to the enterprise and there are often some other similar restrictions.

**PERQUISITES** — See BENEFITS IN KIND, FRINGE BENEFITS.

**PERSONAL EXPORT SCHEME** — Goods exported from a country are not normally subject to that country's customs duty or sales taxation. When goods are bought within the country by tourists who intend to take them away, there should also, in principle, be no duty or tax on such "personal" exports. Accordingly many countries have schemes whereby tourists may buy goods free of tax, etc., either in duty-free shops, or in other shops where either the goods are delivered direct to the departing ship or plane; or on initial payment of duty with subsequent refund being made at the tourists' departure.

**PERSONAL HOLDING COMPANY** — A personal holding company, i.e., a private company the shares in which are owned by the taxpayer (or by him and his wife) personally, is usually set up to hold his investments. The company may be set up in a tax haven in order to gain a tax advantage, but where the taxpayer resides in a developed country such as the U.S.A., the U.K. and other European countries, Australia, Japan, etc., there are usually tax laws which deem the taxpayer to have had the income of the holding company (personal family holding company in Japan) distributed to him for the purpose of calculating his tax.

**PERSONAL RELIEFS** — Personal reliefs, also known as personal allowances, or personal exemptions, are granted to individuals as deductions from income in computing their personal income tax. There is usually a deduction for the individual himself, and others for his dependents, wife, children, and indigent relatives. There is at present a trend among countries which grant FAMILY ALLOWANCES (q.v.), i.e., cash allowances towards the support of a taxpayer's children, to phase out personal relief for the same children.

**PERSONAL TAX** — This term is applied to income tax on individuals, as distinct from tax levied on corporate and other bodies of taxpayers. The term is also applied sometimes where there is a schedular tax system and the moderate amounts of schedular tax deducted from different types of income are supplemented by a tax on the total income of individuals, which may be known as a residents' tax, supplementary tax, or personal tax. (See SCHEDULAR TAXATION.)

**PERSONELE BELASTING** — (Belgium, Holland) A minor tax on real property.

**PERSONEN BELASTING** — (Belgium) Personal income tax.

**PERSONENBEZOGENE GESELLSCHAFT** — (Germany) Closely-held company.

**PERSONEN TEN LASTE** — (Belgium) Dependents of the taxpayer for whom he may claim personal tax reliefs.

**PERSONFRADRAG** — (Denmark) Personal reliefs.

**PETROLEUM REVENUE TAX (PRT)** — A tax imposed in the U.K. on profits from the exploitation of North Sea oil and gas. The tax is levied half-yearly at the rate of 60 percent. The tax commenced with half-yearly production periods ending after 12 November 1974, the tax rate being 45 percent for periods up to 31 December 1978.

**PHANTOM TAX** — The tax which would have been paid on its profits by a PIONEER INDUSTRY (q.v.), which has in fact been exempted under TAX HOLIDAY (q.v.) provisions, but nevertheless is "recognised" for tax relief purposes under a TAX SPARING (q.v.) article in a double taxation treaty.

**PHASENPAUSCHALIERUNG SYSTEM** — This is the system under a cascade tax whereby the whole of the tax due at different stages of production and distribution is covered by a single charge to tax at one stage at a rate of tax which is equivalent to the total amount likely on average to have been levied at the various different stages of distribution. (See also FORFAITAIRE.)

**PHYSICAL HANDICAP, TAX RELIEF** — Some countries provide additional personal tax reliefs to physically-handicapped individuals, e.g., Japan grants additional relief which varies within certain limits according to the severity of the handicap. The U.S.A. grants an additional personal exemption to blind persons. Most countries provide cash benefits to the handicapped through state welfare schemes which may make tax relief unnecessary.

* With the assistance of the staff of the International Bureau of Fiscal Documentation.

**PHYSICAL INGREDIENT RULE** — This is the rule in the U.S. state retail tax legislation by which it is laid down that goods becoming actual ingredients in other goods are exempt from retail sales tax.

**PIONEER INDUSTRY** — The term "pioneer industry" is usually encountered in legislation in developing countries designed to encourage the setting up of industries which do not already exist in the country or which exist on an inadequate scale. Such industries are often classed as "pioneers" and granted tax and other concessions which may include income tax holidays (or exceptional allowances for depreciation), freedom from customs duties on imports of building materials and equipment, and sometimes raw materials, for a limited period of years, and land and buildings, initially at sub-economic rents. (See also INFANT INDUSTRY, PHANTOM TAX, TAX HOLIDAY, TAX SPARING.)

**PLANNING, TAX** — The term is not exactly synonymous with TAX AVOIDANCE (q.v.) in the worst sense of that word. Nowadays it is increasingly realised that there are fields in which long-term planning can help in producing a more TAX-EFFICIENT (q.v.) way of doing something, and tax codes are in some ways designed to favour one method rather than another. For example, provision for one's retirement may be made in several ways but some tax codes give preferential treatment to saving through life assurance. Disposing of assets to those more needy, or perhaps able to make better use of them, during one's lifetime usually incurs less tax (or even none if there is no gift tax in force) than bequests on death.

**PLAYING CARD TAX** — Japan has a tax on manufacturers of playing cards and mahjong sets, and for a long time the U.K. had a specific excise duty on packs of playing cards. Such levies are obviously likely to be trivial in yield but are part of the pattern of taxing gambling (since cards and mahjong can be used in gaming) and leisure activities.

**PLUS VALUES** — (Belgium and France) Capital gains.

**POLL TAX** — A tax on each member (or each male adult), of the population. (See also GRADUATED POLL TAX, SELECTIVE EMPLOYMENT TAX.)

**POLLUTION TAX** — See ANTI-POLLUTION TAX.

**POOL BASIS** — For the purpose of computing DEPRECIATION or CAPITAL or WRITING-DOWN ALLOWANCES (q.v.) in respect of machinery and plant or other qualifying assets it is administratively convenient to "pool" all assets which qualify for the same rate of allowance, and this method is accepted by various tax administrations, e.g., Canada and the U.K., and in fact most countries that use the REDUCING (or DECLINING) BALANCE METHOD of computing relief. The cost of additions is added to the written-down balance of value of the machinery, etc., and the proceeds of sales of old machines or scrap is deducted from the total, the depreciation allowance being calculated on the single figure of the adjusted balance.

**POOLING** — For the purpose of computing capital gains tax on sale, e.g., of shares in a quoted company, where there have been several purchases of the particular shares over a period of time and the sale is of only part of the holding, pooling treatment may be prescribed (as in the U.K. capital gains law) to determine the cost of the shares sold. All purchases are totalled and the average taken to represent the cost of the part of the holding sold.

**POOLS BETTING DUTY** — In the U.K. a levy on the stake money on pool betting (principally applying to sums staked on greyhound track totalisators and betting by coupons, mainly on football match results). (See also FOOTBALL POOLS TAX.)

**PORTFOLIO HOLDING COMPANY** — A company set up to hold investments rather than to trade in them. (See also PERSONAL HOLDING COMPANY).

**POSSESSIONS CORPORATION** — A U.S. corporation operating in a U.S. possession overseas, e.g., Puerto Rico, receives special tax treatment, the object being to encourage investment in these areas.

**POST-CESSATION RECEIPTS** — Where there are post-cessation receipts related to some activity after the formal termination of the trade or profession, tax liability would arise and this is confirmed in legislation in some countries which is designed also to counteract avoidance techniques related to receipts after cessation.

**POST-WAR CREDITS** — In Britain, in the period from April 1941 to April 1946, covering 5 fiscal years (mainly falling within World War II), earned income relief and personal allowances for income tax purposes were reduced and the extra tax payable in respect of these reductions was treated as post-war credits repayable after the war. In the post-war period, credits were made repayable at retiring age (eventually to men aged 60, women aged 55) and in certain other circumstances, e.g., death, blindness, disablement, and long-term sickness or unemployment. Finally, all outstanding credits were made repayable unconditionally in 1972.

**POST-WAR REFUND** — The EXCESS PROFITS TAX (q.v.) which operated in Britain for the period from April 1939 to December 1946 was charged at 100 percent for the period April 1940 to December 1945 and of the 100 percent 20 percent was to be refundable as a post-war refund. The refunds were, in fact, made reasonably soon after the termination of the tax on December 31, 1946 to taxpayers who incurred expenditure on re-equipment, etc., against which the refunds could be used as credits.

**POUNDAGE** — A levy which originated in 1891 and was used for a time to pay the staff of surveyors of taxes in Britain. Since the yield from the levy depended on the amount of tax assessed and collected, there were the usual allegations encountered under such systems that taxpayers found difficulty in having their assessments reduced. The term "poundage" has other connotations. As regards LOCAL RATES (q.v.) in Britain "poundage" is the number of pence in the £ (equivalent to percentage) at which rates are levied. The charge for a postal order issued by the British Post Office is also known as "poundage".

**POVERTY SURTAX** — The expression is used to describe the position arising from the FAMILY INCOME SUPPLEMENT (q.v.) and other income-related welfare, educational, and other benefits and abatements. Where the family's earnings rise above certain limits, reduced benefits are due, and it may be that the cost in lost benefits represents a very high percentage of the increase in earnings, thus appearing similar to a high marginal rate of tax, or SURTAX (q.v.).

**POVERTY TRAP** — The position in which the breadwinner who has a low income and substantial responsibilities, when by striving to and succeeding in earning more, finds that the loss in benefits may nearly equal or even exceed his increase in earnings. (See also POVERTY SURTAX.)

**POWER TAX** — A tax on power (measured by the use of electricity, fuels such as coal, gas, or oil, etc.) has sometimes been advocated on the grounds, inter alia, that a person's affluence or the profitability of a business is proportionate to the amount of power used. A completely logical case for such a tax cannot be made out because it cannot be shown that the grounds referred to are wholly valid. (See also PUBLIC UTILITY TAX.)

**PRAEFERENCEAKTIE** — (Denmark) Preference shares or stock.

**PRECOMPTE** — (Belgium, France) A prepayment of tax, usually by withholding.

**PRECOMPTE MOBILIER** — (Belgium, France) A pre-payment by deduction at source, e.g., of income tax on dividends or interest paid on securities, including bearer bonds.

**PREEMPTION, DROIT DE** — The right of the French tax administration to buy real property at the value (increased by 10 percent) which has been declared for the purposes of the registration tax at the time of transfer of ownership. (See also UNIVERSAL VALUES.)

**PREFECTURAL TAXES** — Local taxation in Japan, where prefectures and municipalities, the units of local authorities, have power to levy taxation.

**PREFERENTIAL DEBT FOR TAX** — Most countries provide that tax unpaid should have preference over other debts in the event of the bankruptcy of an individual or liquidation of a company. This is a reasonable provision since tax was originally a debt from the taxpayer to his sovereign, but the preferential treatment is usually limited to the tax for a particular year, other tax ranking with other debts on an equal footing.

**PREMIUM ON LEASE** — In the U.K. the granting of a lease subject to payment of a premium involves additional income tax based on the use of a formula for spreading the premium over the term of the lease. Sale of a premium is usually a subject for capital gains tax. Most countries accord broadly similar treatment to leases.

**PREMIUMS ON LIFE ASSURANCE POLICIES, ANNUITY CONTRACTS** — See LIFE INSURANCE RELIEF, PENSION SCHEMES, RETIREMENT BENEFIT SCHEMES.

**PRICE, ARMS' LENGTH** — The concept of an arms' length price is relevant to various kinds of taxation, e.g. customs duties, stamp duties and capital gains tax on the disposal of property, the valuation of goods internally or domestically consumed by taxpayers who are subject to sales taxation, and to income taxation on their profits. The allocation of profits between head office and the branches of a concern trading in several countries, or between associated persons or companies in an integrated business may also depend on arms' length pricing, etc.

**PRICE CONTROL** — See QUASI-TAXATION.

**PRICE, EFFECT OF TAX ON** — See ESCALATION, PYRAMIDING.

**PRIORITY FOR TAX** — See PREFERENTIAL DEBT.

**PROBATE DUTY** — A tax payable when an executor or beneficiary takes out probate for the estate of a deceased person. The term may refer merely to a moderate stamp duty on documents or may be applied to the DEATH DUTY (q.v.) charged as a revenue or "redistributive" levy on the assets passing at death. In Britain, Probate Duty was in force from 1694 to 1894 (finally as a 3 percent levy on the value estates over £ 1,000) when it was replaced by Estate Duty.

**PRODUCTION, FACTORS OF, TAX ON** — See FACTORS OF PRODUCTION.

**PRODUCTION GOODS** — The term applied to goods which are, in turn, used to produce other goods. The term may be applied accordingly to equipment and machinery, but is also sometimes applied to other goods which are not embodied in the products but may serve as catalysts in the production process.

**PROFESSIONAL TAX** — Annual taxes are sometimes levied on those carrying on professions. Sometimes the levy may be a kind of registration fee relating to the administrative cost of supervising the activities of various professions for the protection of the public. Occasionally, and usually inadvisedly, such taxes have been levied for revenue purposes avowedly because those who exercise professions are alleged to have more favourable treatment for income tax purposes than employees, and greater opportunities for evasion and avoidance. To levy a special tax for the last reason is, of course, unsound in principle since it seems to confer a "licence to cheat".

**PROFITS TAX** — The term may be used to denote an ordinary income tax on profits or occasionally a special tax such as that levied in Britain in the period 1946 to 1965 on corporate profits in addition to the ordinary income tax on those profits. The various versions of the British profits tax in its lifetime included a simple levy of tax on profits which was calculated slightly differently from those chargeable to income tax — finally at the rate of 15 percent with an abatement where the profits did not exceed £ 12,000 and an exemption where they did not exceed £ 2,000. At other times the tax was charged more heavily on dividends than on retained profits and the differential rate on distributions varied from time to time with changes in government policy.

[to be continued]

# IFA NEWS

## Mr. DAVIES HONOURED

Our congratulations go to Alun G. Davies, President of IFA, who was made a Commander of the British Empire in Her Majesty's New Year's Honours List.

# Bibliography

## Books

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### AMERICAN SAMOA

INVESTING IN THE FUTURE: AMERICAN SAMOA

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### ARGENTINA

FOREIGN INVESTMENT IN ARGENTINA

By C. Langbehn. The Hague, Fenedex, 1979. 27 pp.
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Bangkok, U.N. Economic and Social Commission for Asia and the Pacific, 1977. 492 pp. (B. 51.409)

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Definitionen und Anwendungsprobleme. By Reinhold Schürer-Waldheim. Vienna, Manzsche Verlags- und Universitätsbuchhandlung, 1978. 164 pp., 41.50 DM.
Monograph discussing the principles of valuation in Austrian tax law, e.g. the concepts of market value, sales value, going concern value etc., and the problems of application of these principles with respect to income tax, net worth tax, inheritance tax, turnover tax and other taxes. (B. 102.046)

### BRAZIL

DOING BUSINESS IN BRAZIL

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Brasilia, Ministéro da Fazenda, 1977.
Loose-leaf handbook on import duties. (B. 15.919)

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HOW TO DO BUSINESS WITH CHINA

A seminar for businessmen, bankers, lawyers, accountants and insurance executives. New York, Law Journal Seminars-Press, Inc., 1979. 372 pp.
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Reprint from Taxes and Investment in Asia and the Pacific. Amsterdam, International Bureau of Fiscal Documentation, 1979. 22 pp.
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Study on the use of foreign tax havens and offshore financial centers in the world. Part I explains why tax havens and financial centers exist. Part II deals with the legal framework of international tax planning, residence, domicile, citizenship. The next three parts deal with individual havens and financial centers. Part IV covers international tax planning activities including foreign investment in the United States. (B. 102.250)

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# Contents

**of the February/March 1980 issue**

## ERRATUM

Much to our regret *Dr. Paul Gmuer's* name was omitted in the list of the Board of Trustees of the International Bureau of Fiscal Documentation on the inserted cover pages we mailed together with the December 1979 issue of the *Bulletin*. The complete list is as follows:

# Exploration of Income Tax Treaty Policy Issues in the United States

## National Meeting of the United States Branch of IFA, March 15 & 16, 1979

### PART I - PROPOSED AGENDA: Introduction of the Subject

**by Robert J. Patrick***

#### IN GENERAL

Compared to many areas of U.S. tax law, there has been relatively limited public discussion of the fundamentals of United States income tax treaty policy. It was for this reason that the U.S. Branch of IFA organized a committee on tax treaties two years ago and income tax treaty policy is the theme of this year's National Meeting.

We will be devoting our program today and part of tomorrow to the exploration of certain income tax treaty policy issues. One of the recent criticisms has been that recent U.S. treaties attempt to do too much. On the other hand, it has been argued that one reason the U.S. has so few treaties, particularly with developing countries, is because U.S. treaties typically do so little with respect to changing U.S. taxation of U.S. taxpayers. Thus, an important aspect of our inquiry is what is it that our treaties should be attempting to do?

Concern is also expressed about the treaty negotiating and ratification process in the U.S. The process of negotiation and ratification of agreements will be discussed this afternoon.

Current U.S. treaties are built upon prior U.S. precedent and increasingly upon the Model Convention of the OECD (revised in 1977). One also detects some influence of the UN Group of Experts suggestions for treaties between developed and developing countries, which will be further described this morning.

I would describe the purposes and scope of coverage of comprehensive income tax treaties in this manner:

"*The generally accepted underlying purpose of tax treaties is to contribute to freedom in the flow of goods, capital, technology and personnel across national boundaries by reducing substantive and procedural tax burdens (principally through elimination of double taxation), by harmonizing tax rules, by providing a mechanism for resolving tax disputes, and by authorizing national tax administrations to cooperate with each other in enforcing their tax laws. The United States Model Treaty*[1] *seeks to accomplish these goals by providing rules on the following questions: the right of a country to impose tax on the basis of the connection of the taxpayer, property or activities with the taxing country; the determination of allocable income and deductions to ascertain taxable net income and, in the case of certain withholding taxes, limitations on the rate of tax. The Model further provides a tax credit mechanism for avoiding double taxation of the same income; requires nondiscriminatory tax treatment for treaty partners; and provides machinery for cooperation between tax administrations to resolve tax disputes and to exchange information to enforce compliance with domestic law and treaty tax rules.*"

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* Vice-President of the USA Branch of IFA.


1. *Bulletin* editor's note: This Model Treaty is reproduced in 31 BULLETIN FOR INT'L FISCAL DOCUMENTATION 313 (1977).

These rules subsume a great many policy decisions and cut across a great many substantive rules.

While the U.S. has unilaterally adopted a number of rules to relieve double taxation and accommodate to an international tax context, it is virtually impossible to legislate solutions to the detailed differences between the systems in contrast to resolving problems in a bilateral treaty (as illustrated by the recent U.S./French Protocol). Nevertheless, we need some basic policy guidelines as to what our treaties should be accomplishing and the Treasury has been encouraging such examination.

This morning we shall look at four policy aspects of treaty rules:

1) Treaty rules affecting U.S. taxation of non-resident aliens and foreign corporations;
2) Treaty rules affecting U.S. taxation of U.S. citizens and residents;
3) Issues in the negotiation of tax treaties with countries having integrated tax systems; and
4) Issues in negotiations with developing countries.

## I. TAX TREATY POLICY WITH RESPECT TO U.S. TAXATION OF FOREIGN INVESTORS

Background: 1966 Foreign Investors Tax Act
1977 OECD Model and Commentary
1977 U.S. Treaty Model

### A. Types of income

1. Business activities

The U.S. has adopted the standard treaty rule giving a right of taxation to the country in which a permanent establishment is located with respect to income attributable to the permanent establishment (including types of income that would be treated under separate treaty articles, but for the fact that such income is effectively connected with the permanent establishment and is therefore considered as business profits of the establishment).

The U.S. has tended to support restrictive definitions of what constitutes a permanent establishment, presumably because of the large amount of U.S. overseas activity that we would just as soon have taxable only in the U.S., including export income. There is also a desire to avoid imposing tax in cases where it is difficult to establish allocable taxable income.

— *Should this remain the U.S. position as foreign trade with the U.S. continues to develop?*

2. Withholding taxes: dividends/interest/royalties

Present U.S. treaty rules:

a. *Dividends*

U.S. withholding of 30 percent is reduced to 5 percent on direct investment dividends and to 15 percent on portfolio dividends. The direct investment rule suggests the limited amount of published debate on policy since it is virtually impossible to discover why it is 5 percent on direct investment and not 15 percent or zero, other than that 5 percent and 15 percent are OECD rules.

— *What is the rationale for these reductions?*
— *Why should the withholding rate on intercorporate dividends be 5 percent and not zero?*
— *Should reductions always be reciprocal (without regard to underlying corporate rates)? (The problems of negotiations with countries having corporate/shareholder tax integration will be discussed under* III *below).*

b. *Interest/royalties/equipment leasing*

Present U.S. policy is to seek exemption at source. The usual justification relates to the difficulty in achieving the equivalent of a net income tax if there is a positive rate of withholding.

3. Real property

In the case of real estate, the treaty provisions of the recent past have provided for taxation on a net income basis for rental income, in some instances on an annual election basis (which is no longer permitted).

4. Capital gains

U.S. Treaty rules on capital gains have tended to follow the 1966 Foreign Investors Tax Act and to exempt foreign investors not engaged in trade or business in the U.S. from tax on the sale of U.S. personal property. In form, the treaties retain the right to tax gain on real estate held directly by the seller, even though U.S. law does not at this time impose tax on a passive investor.

The 1978 Tax Legislation called for a Treasury review of U.S. taxation of non-resident aliens and foreign corporations owning U.S. real property directly or through domestic or foreign corporations.

— *Where should U.S. policy move in this area?*
— *What rules are enforceable as a practical matter?*

5. Personal services

The U.S. Treaty rules substantially enlarge the U.S. statutory exemptions for *independent personal services* (limiting taxation to physical presence for 183 days or the existence of a fixed base regularly available to the individual).

The treaty rules also expand the exemption for *dependent personal services* if the employer is not a U.S. resident.

The Model contains a stringent exception, however, for entertainers and athletes, who are limited to an exemption only if total gross receipts of such entertainer or athlete do not exceed $15,000 in the taxable year.

— *Is there a legitimate basis for this discrimination?*

### B. Conduit issues

Treaties are negotiated on a bilateral basis and there is a traditional concept that "concessions" are negotiated to benefit the resident of the contracting states. In practice, of course, the existence of the corporate form of doing business means that third country residents owning stock in a corporation in one country can benefit indirectly from treaties entered into by that country. The significance of this depends upon the combination of the treaty rules, the domestic tax laws of the state of incorporation (e.g., the exemption of holding companies from taxation), and the tax rules of the shareholder's country of residence.

Two questions appear to be involved:

a. What verification arrangements should be employed (and who has the responsibility) to see that persons claiming treaty benefits (such as reduced withholding) are in fact residents of the other contracting state, and

b. What rules should be applicable to investments by corporate investors having shareholders from third countries?

— *Is a refund system for withholding taxes desirable or practicable?*
— *Are rules that require withholding agents to have information concerning the identity of shareholders of foreign corporations or the activities of such corporations desirable or practicable?*
— *What is the role of a "sham" doctrine in this area? What recognition should be given to treaty country corporations (see Rev. Rulings 75-23, 79-65)?*
— *Do these problems primarily arise from having treaties with countries that have or introduce "tax haven" type provisions in their domestic law? What should be done about such treaties? About investment already undertaken in reliance upon the treaty provisions?*

### C. Overall policy

Can we make any general statement as to what U.S. objectives should be in changing U.S. tax rules by treaty to affect the taxation of non-resident aliens and foreign corporations under federal law?

### D. State law

Should U.S. tax treaties, as a matter of policy, apply to state income taxes?

## II. POLICY ISSUES WITH RESPECT TO TREATIES CHANGING U.S. TAX RULES APPLICABLE TO UNITED STATES CITIZENS AND RESIDENTS

Background: Pending U.K. treaty; Pending Israel treaty; Pending French protocol

A unique but standard provision of U.S. tax treaties, the "saving clause", states, in effect, that, with certain specific exceptions, nothing contained in the treaty shall affect the application of U.S. statutory tax rules to U.S. citizens and residents. The one major exception is that the U.S. will provide the principle of a foreign tax credit for the treaty partner's taxes that are specified in the treaty. This is basically a guaranty of a principle unilaterally provided in the Internal Revenue Code.

In considering the appropriateness of the saving clause policy (and the foreign tax credit and other possible exceptions) it appears to be useful to distinguish between different situations:

1) The first case is where a modification of U.S. statutory law by the treaty would result in an aggregate reduction or elimination of both foreign and U.S. tax for the taxpayer. This would be true of "tax sparing" and other incentive provisions, which can be discussed as a policy issue under the topic of negotiations with developing countries.

2) A second situation is that in which there would be a residual right of U.S. taxation (after a credit for the foreign country's tax) and the U.S. is being asked to cede tax jurisdiction in the first instance to the other country, as for example, by accepting a treaty source rule or a characterization of the income from an activity that differs from U.S. law.

3) An additional example of treaty coverage of current importance is the use of a treaty definition of a creditable foreign tax to treat certain foreign taxes as income taxes where their status is arguably unclear or even where the tax does not meet the technical interpretation of an income tax that is being applied administratively.

Questions:

— *In what cases is it appropriate to modify U.S. statutory law? Are there any guidelines to use?*
— *What should be the relationship of such changes in bilateral treaties to other parts of the Code, e.g., the overall tax credit limitation.*

## III. TREATIES WITH COUNTRIES HAVING INTEGRATED TAX SYSTEMS

Background: Ault, "International Issues in Corporate Tax Integration", 10 Law and Policy In International Business (1978); Pending U.S./U.K. Income Tax Convention.

The standard U.S. and OECD treaty rules on taxation of income at the corporate level and upon distribution of dividends is based upon a so-called "classic" system under which income tax is imposed separately at the corporate level and again at the shareholder level. A recent development in the tax rules of a number of countries is the adoption of varying forms of corporate/shareholder integration. Such rules are now in place in Canada, Denmark, France, Germany, Italy and the U.K.

While the details vary, a common theme is that domestic shareholders are entitled to credits (and sometimes refunds) on dividend distributions from domestic corporations. These provisions thus reduce tax on domestic investment by domestic investors (compared to foreign investment by such investors) and they tend to restrict the granting of credits (or refunds) that are given in the case of distribution of dividends by companies solely to domestic investors, or to extend such refunds to only those foreign investors who qualify as portfolio investors.

In order to avoid distortions within the common economic union, the Commission of the European Economic Community in 1975 proposed in a draft directive that all investors resident in EEC countries investing within the EEC be entitled to the flow-through of these benefits within the community.[2] The U.S. has taken the position that countries adopting tax integration rules should extend tax reductions or credits that they give to domestic investors to U.S. portfolio and direct and investors in treaty negotiations.

— *It is proposed that the panel discuss the appropriate U.S. treaty policy with respect to such tax systems, including suggestions for implementing U.S. policy if foreign concessions are advocated. Related questions include the following:*
— *What is the U.S. interest? What is the conceptual basis for seeking such concessions, e.g., non-discrimination, unreasonably high withholding rates?*
— *To what extent would the result of extending integration rules to non-residents be a transfer of revenues between Treasuries or a benefit flowing to U.S. investors?*
— *Do different variations in the foreign systems (compare Canada which does require funding of its shareholder credit and does not give a refund, with the U.K. or Germany) suggest that different treaty approaches are appropriate?*
— *What are the implications for the tradition of reciprocal withholding rates?*

2. See the Special Issue of EUROPEAN TAXATION on the harmonisation of systems of company taxation and of withholding taxes on dividends (Nos. 2-4, 1976).

## IV. TAX TREATIES WITH DEVELOPING COUNTRIES

Background: Surrey, "United National Group of Experts and The Guidelines for Tax Treaties Between Developed and Developing Countries", 19 *Harv. Int'l Law Journal* (1978).

Apart from the extension of prior U.S. treaties with former colonial powers to their former colonies, the U.S. has only a handful of income tax treaties in force with developing countries. It is proposed that the panel discuss the U.S. negotiating situation.

— *Why do we want treaties with developing countries?*
— *What is the interest of the developing countries?*
— *What are our differences?*
*A. The tax incentive issue: Is it an appropriate time to re-examine the question of incentives as a part of U.S. economic policy (tax sparing, investment credit, other proposals)?*
*B. What are the substantive treaty rules that separate the U.S. and Developing countries and can we find solutions? In this connection, it would be useful to outline the work of the UN Group of Experts on the topic of Treaties Between Developed and Developing Countries.*
— *Increased source jurisdiction*
— *Taxation of services*
— *Problems relating to the allowances of deductions*
— *Discriminatory tax rules*
— *Soak-up taxes*

# PART II
## Proceedings of the Technical Session of March 15, 1979*

Mr. Tom Jenks, chairman of the Washington Regional Branch of IFA welcomes the participants to the third annual national meeting of the USA branch of IFA.
The first speaker, Marianne Burge of Price Waterhouse and Company, brings the meeting up to date on the status of treaty negotiations.

### STATUS OF TAX TREATY NEGOTIATIONS
*Marianne Burge*

Monitoring the status of tax treaty negotiations seems to be like trying to get a firm hold on a amoeba, it always seems to slip out of your grasp. I have tried to prepare a list of the current status of our treaties, as of February 28, 1979, [Attached as Appendix to these Proceedings] but it is probably more prudent to describe it as a discussion draft since I am sure that before the meeting is over representatives from the Treasury will have pointed out that I am not up to date on all items. But al least we will have an update as of March 15 by the time we leave the meeting.

In June, 1977, the USA branch of IFA set up the Tax Treaties Committee under the chairmanship of Bob Patrick. The first duty the committee undertook was to prepare periodic reports for U.S. IFA members on the current status of U.S. treaty negotiations. Since that time the Treasury has introduced a very welcome procedure of holding public meetings on treaties which are in an advanced stage of negotiation. Bob and I have attended each of those meetings to date and have reported on the issues discussed in considerable detail. Since June, 1977 we have prepared and distributed to the [IFA] members three reports:

1. The first report covered the six months through December, 1977.
2. The second report covered January through August 1978.
3. The third report, covering the last four months of 1979, was recently mailed to the members with the U.S.A. Branch President's 1978 report.

The first two reports were published in Tax Management International, in their issues of April and October, 1978 and the current report will also be published by them. So far, each of these reports has contained a detailed discussion of issues and trends in important treaty negotiations. They are intended to provide a record for anyone who is trying to keep track of developments in U.S. treaty negotiations. Here are some of the highlights of the first three reports.

* Reporter, Michael Mulroney, Lee, Toomey & Kent, Washington, D.C. This paper is taken from a recording of the proceedings as edited by the Reporter and by the participants. The commercial organization which taped the proceedings failed to record all participants' remarks. Where gaps in the tape occurred the participants have been gracious enough to supplement their remarks.

### 1. Six months through December, 1977

The first report for 1977 covered the release of the U.S. model conventions for income tax and estate tax treaties. They represent the basic U.S. treaty negotiating positions in general terms. We also reported that the last four treaties ratified by the United States were those with Iceland and Russia in 1975 and Poland and Rumania in 1976. No treaties were ratified in 1977 or 1978. The recent record suggests that Eastern bloc countries have a better chance of concluding treaties with us than with other countries. In any event, in spite of the very active efforts of the U.S. Treasury team, we seem to be far behind other OECD countries, such as France and Sweden, in the number of treaties that we have been able to ratify and have in force, in particular modern treaties dealing with current international tax conditions.

In the first report we also reported on the July, 1977, Senate Foreign Relations Committee public hearings to consider the treaties which had been signed with the U.K., Korea and the Philippines. The report contains a discussion of the issues raised at the hearing. As regards the discussion of the U.K. treaty, Senator Church raised the question of the inclusion of the U.K. Petroleum Revenue Tax ("PRT") as a creditable income tax, and asked the Internal Revenue Service Commissioner Kurtz when the Service would complete its review of the Revenue Rulings dealing with the creditability of OPEC country taxes. As we all know, Commissioner Kurtz heeded this admonition and issued numerous rulings in 1978 revising the interpretations of what is considered as income tax.

We also reported at length on the state taxation issue contained in Article 9(4) of the U.K. treaty. The testimony in favor of the new treaty approach to state taxation was most pursuasive. Nevertheless, as you all know, and as we reported in our August 31, 1978 report, the Senate ratified the U.K. treaty on June 27, 1978 subject to a reservation on Article 9(4). As a result, the U.K. treaty, which had previously appeared in our status summary as signed and awaiting ratification is now back in the list of treaties in process of negotiation. I will be discussing portions of that treaty in a little more detail in a moment.

The 1977 report also contains a list of treaties in force, a short bibliography, and an analysis of recent Revenue Rulings.

### 2. Eight months through August, 1978

The August, 1978 report is of particular interest because in it we reported on the first two Treasury briefings on treaty negotiations with Italy and Jamaica. Since there are no official transcripts or published records of the discussion, the IFA reports are the only available record of the proceedings. Some other organization such as Tax Executives Institute may also be reporting to some of their members on some of the meetings.

### 3. Four months through December, 1978

Our third report, covering the last four months of 1978, refers to the treaty negotiations with Denmark and Canada. The meeting on Canada was the best attended to date and included several visitors from Canada. That report also contains the November 3, 1978, Treasury Release on the current status of treaty negotiations giving dates when negotiating meetings were held or are expected to be held. It also contains news of two estate tax treaties which have been signed, one with the U.K., one with France. It also contains reference to the first of a new breed of agreements which are not described as treaties — the Social Security Totalization agreements with Italy and Germany.

I will now discuss briefly the status of some of the more important treaties which are now under negotiation.

### United Kingdom

The most important one which we have been watching for some years now is the 1975 Protocol for the U.K. treaty. Unfortunately, the attempt to deal with the state unitary tax systems through the treaty mechanism has had the result of bringing this treaty into the limelight where it has become a political concern on both sides of the Atlantic. Since then some people have observed that it has taken only one dissenting voice on one issue to prevent the ratification of the treaty which is acceptable in other respects. For example, the delay in the treaties with Korea, the Philippines, Egypt and Israel, all of which were submitted to the Senate Foreign Relations Committee in July of 1977 and none of which have proceeded to ratification.

### British industry concerned about U.S. State unitary taxation and resulting information disclosure

The present status of the UK treaty is that the U.S. Senate ratified it subject to a reservation on Article 9(4), in order to provide the same income base for both state and federal income tax purposes for U.K.-owned subsidiaries in the U.S. This action has resulted in the negotiations of a third protocol: first, to delete the provisions of the Article 9(4) provision, and second, to meet U.K. requests for concessions to compensate them for the loss of the unitary provisions. Thus, forced into the limelight, the treaty has met with considerable opposition in the U.K. in British industry expressing itself through the Confederation of British Industries, and in Parliament.

It seems that the U.K. has placed a much greater emphasis and importance than we could predict on the unitary issue as it affects British subsidiaries in the U.S. I think U.K. companies are particularly concerned about information disclosure. U.K. companies also fear that the unitary concepts may spread to other states or become a general factor hindering U.K.-owned firms in competing in U.S. markets.

Equally important, however, many U.K. businessmen are opposed to the granting of a refund of one half of the U.K. Advance Corporation Tax, ("ACT") to U.S. parent companies. They perceive this as giving U.S.-owned firms in the U.K. a tax advantage over U.K.-owned firms.

Another growing practical problem for the U.K. is that of the retroactivity of the U.K. refund of the ACT that would apply to U.K. subsidiaries' dividends paid since April, 1975. This problem gets worse as each year passes. Questions have been asked by Members of Parliament as to how much that refund would be. It is obviously going to be very difficult for the British Parliament to explain why hundreds of millions of pounds in U.K. tax money should be sent to America. Negotiations are now underway and probably at an advanced stage. To give the U.K. an acceptable *quid pro quo* for the loss of the unitary provisions, it seems to me that one of the concessions would affect U.S. service companies operating in the U.K. North Sea Continental Shelf. Under the latest protocol they would be considered to have a permanent establishment if they operate in the North Sea for thirty days or more.

### Inclusion of the British Petroleum Revenue Tax as a creditable tax

Another amendment to the protocol was included at the urging of Senator Kennedy who objected in the Senate debates to the inclusion of the PRT as a creditable tax without any limitation. His objection was that this tax which might otherwise not be creditable under the new concepts in Revenue Ruling 78-61, [1978-1 C.B. 221] could result in excess credits which could be offset against other foreign source income. Many people, including some government officials who testified at the 1977 Treaty Hearings, thought that the PRT was a creditable tax even without the aid of the treaty. This notion was challenged when Revenue Ruling 78-424 [1978-2 C.B. 197] was published at the end of 1978 just when the third U.K. protocol was being negotiated. That ruling stated that the PRT is not a creditable income tax. The new protocol will contain some limitation on the amount of credit which will be allowed for PRT, limiting the PRT to the U.S. tax on U.K. oil extraction income.

We hope that in spite of these difficulties, the Treasury will resist any pressures to roll forward the date for which the ACT refund is to be given by the British tax authorities since this would cause considerable confusion. The dates of the treaty do, after all, offer considerable benefit to the U.K.

One example is the elimination of Article XV as it affects the U.K. taxation of U.S. banks in the United Kingdom.

### Disallowance of British Corporation Tax satisfied by payment of ACT as creditable income tax

There has also been a further development in the U.S. in regard to the U.S. foreign tax credit of the U.K. Act in the absence of the treaty. The Manhattan District Director has announced his intention of disallowing the U.K. corporation tax as a creditable income tax to the extent that it is satisfied by a payment of ACT. That part of the U.K. corporation tax according to the Manhattan District, does not meet the criteria for income tax established in Revenue Ruling 78-61 because the advance payment is not measured by gain but by distributions. This might be considered to put more pressure on interested parties to get the treaty ratified because the treaty would provide for the creditability of the U.K. corporation tax including the advance corporation tax. Nevertheless, I think it would be most regrettable if the creditability of the corporate tax was made entirely dependent on the treaty because there may be technical situations in which the U.S. taxpayer may not be able to have recourse to the treaty — situations which the Treasury has not thought of in advance — and also because of the delays in ratification which are not the fault of U.S. taxpayers who have for some years been faced with great uncertainty on the treatment of this tax. I would refer you to the letter from the U.S. Chamber of Commerce dated November 27, 1978 to Commissioner Kurtz. In this letter the Chamber urged the IRS to announce promptly that it will allow credit for taxes imposed by countries having tax treaties with the United States on the basis that the existence of the tax treaty provides implicit recognition that the income tax the treaty has dealt with is a creditable income tax.

Procedurally, the U.K. treaty is in renegotiation. When a third protocol is signed it has been agreed between the two countries that it will first go to the U.S. Senate for ratification and then to Parliament in the U.K. for ratification. We are therefore to be many months away from ratification. Quite apart from any difficulties which may be encountered in the U.S. Senate, the situation in Britain is that there will be an election sometime between now and the Fall. We cannot but wonder whether the present government will wish to debate this treaty in the last few months before an election in view of the opposition that has been voiced from several of its constituencies.

Other important nuances of the U.S.-U.K. treaty negotiations will be discussed today in the panel discussion which will follow. Let me touch on several interesting points as to other countries.

### France

The recently published Protocol to the French treaty seems to be one which may have a good chance of early ratification. This Protocol makes a number of updating changes to the existing treaty. Of particular interest are those provisions which seek to avoid the double taxation of investment income of U.S. citizens resident in France. The French have precipitated the need for this protocol by changing their internal law to make U.S. citizens living in France subject to French tax on their worldwide income. That change was delayed and finally came into effect on January 1, 1979. The new protocol would also exempt U.S. citizens from French tax on remuneration for services while in the United States. This follows to some extent the French territorial concept and also prior practice in France.

Of great interest is the proposed method of avoiding double taxation on U.S. source investment income which would now be subject to worldwide taxation in both countries, with no U.S. foreign tax credit for French taxes on the U.S. source investment income. The treaty provides a complicated technique whereby the U.S. will collect a tax of 15 percent on the U.S. dividends, which is the same rate of tax the U.S. would collect from French residents. The French will allow a credit for the 15 percent U.S. tax against the French tax and the U.S. will then allow a credit for French tax on the U.S. dividend, by converting the source of the dividend to foreign source. This is called the *triple bite approach* and it seems to me that this will form the basis for dealing with this problem in other treaties, such as Canada and Denmark.

### Canada

The treaty with Canada is under active negotiation but there seems to be no specific timetable for completion. There are many issues to be resolved which result from the two countries' close relations and geographical proximity The treatment of Canadian dividends is one serious difficulty. The U.S. would like to see a lower withholding rate than the present 15 percent Canadian rate under the present treaty. The treaty discussions also have to deal with the problems of capital gains taxation for individuals. Canadian rules on taxing departing aliens on unrealized gain and the U.S. rules of taxing them on realized gain can result in timing differences and in double taxation. Agreement on these issues does not seem to be imminent, and possibly the present treaty is basically viewed as adequate by the two governments for the time being.

### Germany

Negotiations with Germany are still at the stage of dealing with the basic issues of German taxation of dividends paid to U.S. parent companies, and the question of discrimination against U.S. shareholders as inherent in the German imputation system. Requests for comments from U.S. taxpayers have been sought by the Treasury. So far, there are insufficient negotiations to warrant public meetings.

### Italy

Negotiations on the Italian treaty seem to be moving at a steady but not frantic pace. The issues there include the treatment of Italy's imputation system, the problem of dual corporate residence (as discussed in our August, 1978 report) which the Treasury proposes to deal with on an "80-20 company" approach.[1] New source rules with respect to royalties are also the subject of discussion of this treaty, reflecting the new interest in the U.S. source rules in general. The problem of Italian local taxes seems to be aggravated by the fact that we cannot include our U.S. state taxes as taxes covered in our treaties. A new treaty does not seem to be imminent.

### Jamaica

There are some negotiations with developing countries. The Treasury briefings on Jamaica are of interest because they represent some of the U.S. tentative concessions to developing countries, short of tax sparing. The principal innovations are to be found in connection with the permanent establishment rules. These are similar to those found in treaties with Korea and the Philippines. The main thrust seems to be to permit the developing country to tax U.S. taxpayers on a net income basis on projects in the country for a certain length of time. The U.S. seeks the benefit of taxation on the net income basis as opposed to a withholding tax on gross income. This will be of importance to U.S.

1. *Bulletin* Editor's note: This would mean that if a corporation would receive 80 percent or more of its gross income from sources within Italy, it would be deemed to be a resident of Italy for tax treaty purposes. Otherwise, it would be deemed to be a U.S. resident under the treaty.

taxpayers if the IRS does not withdraw its ruling on the creditability of the Tanzanian withholding tax on management service fees. See Rev. Rul. 78-234, 1978-1 C.B. 237.[2]

Many developing countries impose heavy withholding taxes on management service fees. While the negotiations are well under way in this treaty, I think it is impractical to believe that treaties with developing countries are the way to resolve foreign tax credit problems which arise from the concept of the Tanzanian ruling, given any practical forecast of the speed with which we will conclude treaties with developing countries.

### Argentina and Nigeria

Negotiations have commenced with Argentina and there are to be discussions with Nigeria, which terminated its treaty with us earlier this year.

### Eastern bloc

The Eastern bloc continues to do well. We have recently seen the publication of a treaty signed with Hungary.[3]

### Estate tax treaties

Two estate tax treaties have been signed recently, one with France, which has been submitted to the Senate, and one with the U.K. which may be submitted shortly. These treaties are receiving insufficient attention and they may have some serious deficiencies. Without public discussion, the U.S. seems to be abandoning its policy of taxing its U.S. citizens on the basis of citizenship with a credit for foreign estate tax on foreign situs property. The new treaty with the U.K. adopts the domicile approach, which the U.S. government always stated to be unsatisfactory as a basis of taxation because we do not know what domicile means from a federal standpoint or even from a state tax standpoint. The estate tax treaties seem to be concerned only with avoiding estate taxation of business excutives dying in a foreign country while on a foreign assignment. Little consideration seems to be given to U.S. private citizens living in those countries for other than business purposes.

### Totalization agreements

Finally, I would like to mention the new breed of agreements which technically are not treaties and which are being concluded by the Social Security Administration: the *Totalization agreements.* These agreements deal with the contributions and benefits for employees working in several countries in the course of their careers. The agreements try to avoid the costs of double coverage and the loss of pension benefits through mechanisms which involve electing out of individual coverage where dual coverage arises and the aggregation or "totalization" of working time in more than one country in computing pension benefits. This is an area which bears watching because it does not come to your attention through the normal tax treaty channels.

Totalization agreements with Italy went into effect in November, 1978, and an agreement with Germany has been submitted to Congress for ratification. Fortunately the ratification procedures do not require affirmative action by Congress. The agreement must be submitted to Congress for ninety days while it is in session and during this period unless either House adopts the resolution to disapprove the agreement it takes effect. The taxation of benefits continues to be covered by the tax treaty.

Foreign social security taxes which are covered by a totalization agreement will not be creditable for U.S. tax purposes.

## PANEL DISCUSSION

*Jenks.* Thank you very much, Marianne, for that excellent analysis of the current treaty status. I was particularly interested in the discussion of the U.S.-U.K. treaty which seems to be in serious trouble on both sides of the ocean.

At this time I would like to turn the podium over to *Bob Patrick*, formerly International Tax Counsel, now with Exxon, who will lead the discussion of current tax treaty policy issues.

*Patrick.* Thank you Tom. I think that we are fortunate in having here today a number of people with backgrounds and interests in the U.S. tax system and tax structure. Those that are participating on the panel this morning are *Daniel Lundy*, Tax Director IT&T, *David Brockway*, International Tax Counsel of the Staff of the Joint Committee on Revenue Taxation, *David Rosenbloom*, International Tax Counsel of The Treasury, *Professor Stanley Surrey* of Harvard Law School, *Leif Muten* of the Fiscal Affairs Department of the International Monetary Fund, and *Hugh Ault*, Professor of Law at Boston College Law School.

### Fundamentals of U.S. income tax treaty policy neglected

Compared to many areas of U.S. tax law there has been relatively little discussion, or at least limited public discussion, of the fundamentals of U.S. income tax treaty policy. It was for this reason that the United States Branch of the International Fiscal Association organized a committee on tax treaties two years ago, and it is the reason that U.S. income tax treaty policy is the theme of this year's national meeting. We are devoting the technical portion of our program to the exploration of certain income tax treaty policy issues. One of the criticisms has been that U.S. tax treaties in recent years have attempted to do too much, therefore have become controversial and so have contributed to the problem of obtaining Senate consent to ratification or, indeed, have impeded the actual negotiating process with foreign countries because of what was being demanded by the U.S. negotiators. On the other hand, it has been argued that the one reason the United States has so few treaties compared to a number of developed countries, and so few treaties particularly with developing countries, is because United States treaties typically do very little with respect to changing U.S. taxation of United States taxpayers, and as a result there is no substantial reason to enter into treaties with the United States. Thus, an important aspect of our inquiry here is what it is that our treaties should be attempting to do. Obviously, concern is expressed increasingly about the treaty negotiating and ratification process with the delays Marianne Burge referred to earlier. The process of negotiation and ratification, and the input that goes into the U.S. tax treaties, will be discussed later by *David Milton's* group. David is a member of our U.S.A. Branch tax treaty committee who has been giving particular thought to the treaty processes.

### Underlying purpose of U.S. tax treaties

Now, United States tax treaties themselves are of course built on the precedent of previously negotiated treaties and increasingly upon the OECD model convention including the revised version of that model in 1977. I think one also detects in negotiated treaties with developing countries the increased influence of the U.N. group of experts on treaties with developing countries. The work of U.N. group in particular will be discussed later this morning. I would like at the outset to give a description of what is a possible way of looking at the purpose, the coverage and

2. *Bulletin* Editor's note: This Ruling provides that the Tanzanian withholding tax on the gross amount of management or professional fees received by non-residents is not the substantial equivalent of a withholding tax and is therefore not creditable under section 901 of the Code. Such taxes imposed on the gross amount of dividends, interest and royalties received by non-residents, however, do qualify as creditable income taxes.

3. *Bulletin* Editor's note: See for a discussion of this treaty Edward J. Leahy: An analysis of the new Hungary-United States tax treaty in 19 EUROPEAN TAXATION 325 (1979).

the intent of the U.S. tax treaties. I think the generally accepted underlying purpose of the treaties is to contribute to the freedom of the flow of goods, capital, technology and personnel across national boundaries and to do so by reducing substantive and procedural tax burdens principally through the elimination of double taxation, by harmonizing tax rules, by providing a mechanism for resolving tax disputes and by authorizing national tax administrations to cooperate with each other in administering and enforcing their internal tax laws.

### The United States Model Treaty

The United States model treaty, which is used as a basis for starting negotiations with foreign governments, seeks to meet those rather broad goals by providing rules on such questions as the right of a country to impose tax on the basis of the connection of the taxpayer, property, or activities in the taxing country and the determination of allocable income and deductions to ascertain taxable net income. In the case of certain withholding taxes, limitations on the rate of tax are imposed which reflect a balance of considerations between the treaty partners, including revenue flows. The model further provides a tax credit mechanism for avoiding double taxation of the same income, requires non-discriminatory tax treatment for treaty partners, and provides machinery for cooperation between tax administrations to resolve tax disputes and to exchange information and enforce compliance with domestic and treaty rules. Now these general objectives and principles incorporated in the treaties subsume a great many policy decisions and cut across a great many internal rules in attempting to harmonize or accommodate the laws of two countries. Part of our focus this morning will be to talk about some of this interaction.

While the United States has unilaterally through its tax credit mechanism adopted rules to relieve double taxation and accommodate foreign tax systems to U.S. rules, it is virtually impossible to encompass all of the detailed problems and the differences which may arise between the tax laws of two countries. I think the protocol recently signed with France illustrates the difficulty in attempting to resolve a number of double taxation problems solely through statutory provisions. One of the themes of our discussion this morning should be when, if ever, it is appropriate to modify United States tax laws by treaty, and what is the proper approach when one is seeking modification to accommodate the internal tax rules of another country. It is clear that we need some basic policy guidelines as to what our treaties should be accomplishing. Fortunately, the Treasury has been encouraging an examination of policy in this area.

### Aspect of U.S. tax policy for treaties

This portion of the technical session will concentrate on four aspects of U.S. tax policy for treaties. *First*, the treaty rules affecting U.S. laws on the taxation of nonresident aliens and foreign corporations; *second*, those treaty rules that affect United States taxation of United States citizens and residents, *third*, issues in the negotiation of tax treaties with countries having integrated tax systems; and, *finally*, current issues which arise in negotiations with developing countries.

### U.S. taxation of foreign investors

The first of these categories, which is really a question of the development of U.S. tax policy with respect to U.S. taxation of foreign investors, also gives us the opportunity to review to some extent the structure of tax treaties and the types of substantive rules that are applicable in determining when a country has a right to tax and under what conditions. My own comment on each of these subjects hopefully will be fodder for comment by our panelists.

I think that United States policy in treaties with respect to the taxation of foreign investors or foreign persons doing business in the United States has tended to grow out of a principal focus by the United States on U.S. business or individual U.S. investors investing or operating abroad. As the historical pattern has developed, the treaty rules which were looked at had to do with when Americans should be taxed abroad, what sort of permanent establishment limitation do we want to have foreign countries apply to Americans, what sort of withholding rates do we want to have on income received by American investors, and, only in turn, through a general notion of reciprocity, have we asked what rules the United States should adopt on its side with respect to taxing foreign investors in the United States. I suggest that the orientation has been to look primarily at these rules in terms of their effect on U.S. investors abroad. This should also be put in some general context today as to what United States policy is toward foreign investment in the United States and how that is reflected in United States tax treaty considerations. Historically, we had the major change in U.S. domestic tax rules in the 1966 Foreign Investors Tax Act which in large part was intended to facilitate foreign investment in the United States. There have also been efforts in subsequent years to eliminate U.S. withholding taxes on the investment income of foreign investors and other activities to stimulate foreign investments in the United States. I asked *David* [*Rosenbloom*] if he could comment today on how the Treasury perceives U.S. tax policy with respect to foreign investment, and how that might be reflected as a general policy matter in any given treaty.

### Internal Revenue Code and U.S. tax treaties are in need of harmonization

*Rosenbloom.* You said tax policy. I think the first point to make in regard to United States law in that regard is that the Code and our treaties are badly in need of harmonization. We use an entirely different language in a treaty than we use in the Code, a language which we have inherited from, in large part, either prior treaties or the OECD. Many of the words that are determinative under the treaties are not found in the Code and the treaty concepts have grown up as a kind of a parallel body of law.

Our basic approach to foreign investors in the U.S. is to paint in the Code on a very broad canvas, to cast our net extremely wide without any effort (with the exception of the section 864 rules) to fine tune the system. We then tend to carve away from that broad assertion of jurisdiction in individualized treaty arrangements, treaty bargains. Thus, I assume, when you speak of tax policy, what you are really asking is what policies are we following in the treaty negotiating process. There is, incidentally, work to be done in the Code, both in putting the Code and the treaties into something of a more parallel track, and in reviewing the 1966 Act — which in some respects is to say the least, a little peculiar.

In the treaties I think you are quite right, *Bob* [*Patrick*], the inherited view — and probably the still prevailing view — is to approach negotiations with most countries, (there are one or two fairly insignificant exceptions) with the background knowledge that there is greater outflow of U.S. investment to that country than inflow from that country. But I think that our policies would not be significantly reversed if the shoe were on the other foot, at least insofar as the relationship with most developed countries is concerned. We would still, as a matter of general tax and treaty policy, not want to assert source basis of taxation to the full extent that our Code allows. We have too many problems areas; after all, the residence country is ultimately in the better position to tax its own residents than the source country.

## Saving clause in U.S. tax treaties

*Patrick.* Let's shift gears a bit and talk about another aspect of U.S. treaty policy that is of increased importance in view of the general concern over foreign tax credit interpretations. That is, not the taxation of foreigners investing in the U.S., but rather to what extent the United States in its treaties should be modifying United States tax rules concerning the taxation of U.S. citizens and corporations. As you all know in our tax treaties we have a very standard provision, basically unique to the United States, which says that notwithstanding any of the provisions of the treaty, United States citizens, residents, and corporations will be taxed as if the treaty had not come into effect: we will simply apply our domestic law and tax United States citizens under this saving clause with some limited modifications for foreigners who are resident in the U.S. Our treaties do contain a limited exception to the saving clause that, in effect, guarantees at least the principle of a foreign tax credit for the United States citizens and residents with respect to the foreign income taxes covered by the treaty. That exception stands as a guarantee to the other treaty partner that, for those taxes considered income taxes in the treaty, the U.S. will give a foreign tax credit, substantially in the form or method which is applied from time to time in the Code. Whether it be per country or overall limitation or other procedural limitations, in any event the principle will be maintained. It seems that in considering the appropriateness of the saving clause policy, it is useful to distinguish several different situations.

The *first* case might be a modification of U.S. law applicable to U.S. citizens and residents when it results in an aggregate reduction or elimination of both foreign tax and U.S. tax. Tax sparing would probably be the best example of that, which we will talk about a little later when we get to treaties with developing countries. That is one type of case where U.S. law could be affected by effectively eliminating taxation for U.S. citizens.

The *second* situation is one in which the U.S. retains a residual right of taxation, after a credit for foreign taxes, but the U.S. in its negotiations with the foreign country is being asked in the first instance to cede tax jurisdiction to the foreign country. This would arise, for example, where they want a change from what would be our statutory source rule to give them a right to tax in the first instance, and the correlative of that taxation right would be that the U.S. would give a foreign tax credit for their tax on what is now U.S. income but would become foreign source income from that country. In this example, we are still modifying the application of U.S. tax laws to United States citizens, but it could be characterized as a determination of which country has the initial right of taxation and which has the residual right of taxation under a foreign tax credit system. We have seen previously some rulings on this dealing with the Belgian treaty, the Japanese treaty in a case involving U.S. crew members on Japanese aircraft, in which those treaties are interpreted as changing the source rules to provide a foreign tax credit for foreign taxes on what, under the Code would be U.S. source income. But in those cases it is then treated as income from the treaty country and they tax it and then the U.S. gives the credit. Similarly, as Marianne Burge explained, in relation to the protocol to the French treaty, efforts are now being made to deal with the situation of U.S. citizens residing in a foreign country that taxes on a residence basis and who receive income from U.S. sources, thus creating a very difficult foreign tax credit issue as to who taxes the income first and who gives a credit.

Now, a *third* example of treaty coverage affecting the U.S. taxation of U.S. persons that is of current importance is the question of what is a creditable income tax. Perhaps the most notable recent case is the U.K. treaty where you have both Petroleum Revenue Tax and the Advanced Corporation Tax as taxes covered under the treaty. Most people seem to agree that where there is a reasonable doubt about whether or not a particular tax is creditable, it is a proper function of a tax treaty to clarify the status of the tax. And you could have something like the provision in the Israeli treaty which treats forced loans for the period of time that they are outstanding as if they were taxes subject to being treated as a refund of tax, when and if these loans are repaid to the U.S. investor, even though contrary to previously published rulings on that type of loan, and would not be considered a creditable income tax in the absence of the treaty.

The question I would raise for the panel is *in what cases is it appropriate to modify U.S. statutory law affecting the taxes of U.S. citizens and residents?* Are there guidelines to use in this context? I think we have just seen some indication of Treasury's thinking on this in Assistant Secretary *Lubick's* testimony for [Congressman] *Rosenthal's* subcommittee two days ago in which there was some discussion in the context of oil tax credits as to the appropriateness and inappropriateness of the use of treaties to deal with the foreign credit provision. Perhaps during our discussion *David Rosenbloom* might want to summarize generally the sentiment expressed there. May we have some comments, first, on whether there is a consensus on the panel that the types of situations described — at least the one of changing source rules — is appropriate, and second is the use of treaties for providing for the creditability of foreign taxes an appropriate and acceptable use of the treaty process?

*Ault.* The first one I think is easy. It seems to me it is perfectly consistent with the purposes of tax treaties. The situation is one in which double taxation would literally arise if there is not some fine tuning of the two jurisdictions. It comes out of the negotiation process in which we are not changing our domestic source rule but fitting it together unilaterally with somebody else's source rule given the fact that the source rules are not written in stone someplace. It seems to me the Japanese rule is perfectly consistent with our treaty policy and acts to fit the edges of the two systems to avoid double taxation in this particular situation.

## German pension costs

*Lundy.* I am thinking of the situation involving German pension costs under which it is extremely difficult to fund German pensions. As a result, German companies have very large accrued but unfunded pension liabilities. They are even preferred liabilities; they are the strongest liabilities the Germany company has. When a U.S. company receives a dividend from this German subsidiary the IRS takes the position that the earnings and profits in the section 902 computations have to be made by treating those German pension costs as not being a proper charge against earnings and profits. As a result the credit can be diluted. Assume this is not a proper charge against earnings and profits, which I don't concede in any way. But even if it were, it seems to me the German treaty provisions could be applied here in order to give a credit that would override internal law. The provision in the German treaty calls for giving appropriate credit for German taxes paid. When you receive a dividend from a German company it seems to me in a case like that the treaty could be very fruitfully used to iron out a problem that otherwise creates timing differences and loss of credits where double taxation really wasn't intended.

*Muten.* I would say that the fact the United States stands practically alone in the world in taxing nonresident citizens would make it a rather national thing for the United States to be more ready to make such concessions than other countries. It would seem that this whole idea of taxing citizens throws a monkey wrench into the machinery, and it is up to those who throw it in to pull it out.

*Ault.* I guess I would distinguish between this case and a source rule case. I think I would have a little more hesitation in saying that in the situation in which they have a different principle under which deductions are allowed should be accommodable in the treaty. I would be a little slower to say the treaty negotiation process was appropriate than I would be to say that a different source rule was appropriate which derives purely out of the application of the international aspects of the U.S. system.

*Patrick.* Would you take that same view with respect to, say, granting a deduction for gifts to charities in the other treaty country?

*Ault.* I would take the same view, yes.

*Patrick.* Do you have a way of drawing a line. You may be more cautious. Is it inappropriate?

*Ault.* I think I would try to distinguish three kinds of situations. One is a situation of international rules and it is the problem of harmonizing those international rules. That I think is the classic case for treaty harmonization. Secondly, where there are problems involving provisions in the countries which are basically determinations of income. Thirdly, since Professor Surrey is here and therefore we cannot get through the morning without saying tax expenditures, there are provisions that involve tax expenditures. In the latter two cases I think I would want to think about how I would be applying my treaty principles.

*Surrey.* I think I would agree with *Hugh* [*Ault*] in general, but in the source rule aspect as he indicated you are largely dealing with an overload, and the question is — should there be an overload with the two taxes. You are dealing to some extent in creditable taxes, where the line is obviously indistinct. The treaty purpose is to eliminate overload of two income taxes. When you depart from that and say the treaty is to make a concession to reduce really the basic U.S. rule of what is net income I think it is quite a different matter and I would agree with *Hugh* [*Ault*] on that.[4]

*Rosenbloom.* I guess I believe the treaties can be used for any of the three purposes that have been enunciated, in appropriate circumstances. I think the source rule changes presuppose that fact. Many of our treaties do indeed change United States source rules. That is a lot of water under the bridge. I think the changes are probably correct. If we were not able to change United States source rules in treaties we would have even fewer treaties than we do. I also think that a treaty should — and by this I do not necessarily mean that all U.S. treaties do — guarantee a credit independently of the Code. Now it is one thing to guarantee a credit independently of the Code for another country's taxes which would otherwise be independently creditable, or which the negotiators believe would be independently creditable. It is another thing to take the next step and credit taxes that there are some doubts about. I think that is appropriate under carefully controlled circumstances and I think *Marianne* [*Burge*] said that earlier in her exposition. Incidentally, I noted *Marianne's* [*Burge*] comment that the ruling on the Petroleum Revenue Tax settled the question of whether that tax is creditable. I think that is a very nice view, Marianne, but I do not think it is exactly accurate. Nobody really knows, and we will not know for many many years on some of these very difficult credit questions, what is creditable and what is not creditable. I think there are plenty of grey areas. At the same time, I think there are also things that we know are not creditable.

I would hesitate a long time before agreeing to credit an economically important type of payment that I felt, really flat out, did not have a chance of being a creditable income tax for United States purposes. On *Dan Lundy's* point, I think that too is probably something that can be discussed in a treaty context. The question there, really, is whether (and in describing it this way I am giving the German situation every benefit of the doubt) if you have an amount which is accrued on the books of a German subsidiary and which cannot be used under any circumstances to pay dividends to the United States parent, but for one reason or another the item does not meet United States rules for deductibility because, for example, it is a pension which does not qualify under ERISA, should the United States in order to avoid dilution of the credit recognize not that income is reduced — that's different — but that earnings and profits are reduced by that amount. That amount — remember my assumption of it not being able to be used for dividends — will never be available to reduce your earnings and profits to zero, so you will always have less than one hundred percent of the credit available. I think that is a legitimate treaty issue. But I diverge sharply from *Dan* [*Lundy*] if he is suggesting that one could find a resolution of that issue in any United States treaty as it presently exists, with the possible exception of the newly negotiated treaty with Denmark.

*Patrick.* Thank you. I am going to raise one more question before we take a break, and then turn to two major topics of interest: treaties with countries with integrated tax systems and treaties with developing countries. I would like to ask *David* [*Rosenbloom*] just one more question. It is part of our first topic of taxing foreigners in the United States and should be mentioned at least briefly here because it has been such a keen treaty issue for the last couple of years in connection with the U.K. treaty considerations. That is whether U.S. tax treaties affect taxation by the states of the United States and what I would simply ask *David* [*Rosenbloom*] at this point:
One, what is the U.S. negotiating position when faced with a request by foreign countries that U.S. state taxes are covered by our treaties; and,
Two, if he would give some suggestion as to how he sees the fact that the decision of the Senate on this issue has affected U.S. treaty negotiations with other countries.

## Can tax treaties affect U.S. state taxes?

*Rosenbloom.* I think we all know the history of the United Kingdom treaty dealing with U.S. state taxation. It was clear, at least at the time of the Senate vote, that a two-thirds majority could not be mustered for a treaty that would bind the states even to the relatively minimal extent of Article 9 (4). I think we assume that continues to be the case; and if anything, Congressional sentiment is perhaps a little bit stronger today than it was then. Since we like to negotiate treaties that we have some chance of getting ratified we are not presently including any general provision covering U.S. state taxation in our treaties. That notwithstanding, the case for allowing the individual states to experiment with foreign taxation is extremely weak. My personal view is that tax treaties are really every bit as much an instrument of foreign policy as they are of taxation. It seems to me that the states are recognized to have very little legitimate role in the foreign policy areas. It is only when the word "tax" appears in the caption that everybody gets excited. I like to believe that the right long-range answer is for the United States to cover state taxes generally in its tax treaties, particularly since we regularly insist that any country that has significant state taxes cover its own state taxes on its side, since our state taxes are usually by no means as substantial as theirs. But it is not in the cards immediately. I do not exclude it in the long run.

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4. At this point in the proceedings the tape failed to pick up additional remarks by Professor Surrey. In general, those comments paralleled several that were contained in his article, "United Nations Group of Experts and the Guidelines for Tax Treaties between Developed and Developing Countries", 19 Harvard International Law Journal pp. 1-70 (1978). The essence of this article also appears in PUBLICATIONS OF THE INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION No 25: THE EXCHANGE OF INFORMATION UNDER TAX TREATIES at 34 (1978).

*Patrick.* Next, let us try to divide the world up into a couple of major problems geographically for our treaty negotiations. I think it is fair to say that the major issue today with negotiations with developed countries is basically the question of the interaction of our tax system and our tax treaty rules with countries having integrated corporate — shareholder tax systems. I refer everyone to *Hugh Ault's* article for examples on some of the international issues in corporate tax integration in the volume of Law and Policy in International Business in 1978 that was dedicated to Nate Gordon.[5] I have asked *Hugh* [*Ault*] today if he would introduce this topic for our discussion and then we will let the panel comment on what they perceive as the relevant considerations and issues; what U.S. policy has been in this area; and, indeed, what it should be. Hugh.

5. Hugh Ault, International Issues in Corporate Tax Integration, 10 Law and Policy in International Business 401 (1978).

## INTERACTION OF THE U.S. TAX SYSTEM AND U.S. TAX TREATY RULES WITH FOREIGN INTEGRATED CORPORATE-SHAREHOLDER TAX SYSTEMS

*Hugh Ault*

With an audience like this I am assuming you all are generally familiar with the integration systems as such and also are in general familiar with the problems that we are going to be talking about. I think it would be useful to give a little background about exactly how the problems arise and what are the arguments. Basically, the treaty questions in the integration context arise because all of the integration systems in their internal structure do not grant the imputation credit to foreign shareholders. Having finally to grant the credit as a matter of domestic law, the issue then moves to the treaty level which is our principal concern today.

I think discussions can really be divided into two parts. First, questions of theology, and second, questions of applied religion. I think maybe you can understand the applied religion better if you get the theology first.

### Basic principles of corporate-shareholder tax integration

If you look at the integration countries their theological principles are something like this: The first commandment is that the integration system operates entirely at the shareholder level. At the corporate level all corporations, as such, are taxed the same regardless of the nationality of their shareholders. At the shareholder level where the integration system operates it is appropriate to distinguish between shareholders who are subject to worldwide taxation and shareholders who are not subject to worldwide taxation. And therefore it is appropriate to grant the credit to worldwide tax shareholders and inappropriate to grant the credit to foreign shareholders. This failure to grant the credit to foreign shareholders is not a matter of discrimination because everything is operating at the shareholder level rather than at the corporate level, and there are legitimate distinctions between foreign and domestic shareholders.

Now, assuming that some heresy creeps in and you are going to grant some credit to foreign shareholders, the second integration commandment is that in any event you will not give the credit to foreign corporate shareholders. There are really two reasons: *one*, granting the credit to corporate shareholders does not have anything to do with the basic idea of integration which is after all to integrate individual and corporate taxes and integration is not appropriate as long as the income is still in the corporate level solution, and *secondly*, the integrationists say that the responsibility for granting relief comes at the point of distribution to individual shareholders and from the country of residency of the corporation that is making the distribution. So when, for example, dividends come from a German company or a U.K. company to a U.S. company under the European view as expressed in the E.E.C. draft model directive it is the responsibility of the U.S., if anyone, to give distribution relief when the ultimate individual shareholders get the distribution.

### United States: existing corporate-shareholder tax integration systems are discriminatory

The U.S. sees the world quite differently. We have a different set of ten commandments. Traditionally, the U.S. has argued that the failure to grant the credit was discriminatory and this argument has taken several forms.

Most simply stated it says there is really no corporate tax in an integration system since it is really just a withholding tax on shareholders and therefore it is a withholding tax that violates international withholding norms, Germany's 36 percent, for example.

A somewhat more sophisticated view, I think, is to say that despite its formal structure the integration system does operate at the corporate level. It operates at the corporate level because it gives the corporation the ability to increase the return to shareholders by increasing the level of distribution. This is true whether the system takes the form of a split rate system, in which an increased distribution lowers the corporate rate, or in the case of imputation system in which a dollar of dividend paid allows the corporation in effect to distribute through the government an additional amount of dividends to the shareholders. So, if the imputation system is really seen as operating at the corporate level then it is a discriminatory system and the failure to grant the credit to U.S. shareholders is discrimination.

This principle of U.S. theology is usually joined with a second principle, that is, that withholding tax rates ought to be reciprocal and that because a country has a lower corporate rate than we do is no reason for it to have a higher non-reciprocal withholding rate. Those are the ten commandments, slightly summarized, of integration in the U.S.

### Corporate-shareholder tax integration in practice

When we move to the level of applied religion where theological purity has to be tempered with political and economic reality the situation gets a little bit more complicated. There have been two important developments here. One as you all know, France is granting the credit in its treaties to portfolio investors. Also, the U.K. in the U.S.-U.K. treaty which still awaits ratification, granted one half of the distribution relief to direct investors. The U.K. solution works in part because the U.K. had only partially integrated its system; that is, only about half its corporate tax was integrated at the shareholder level. This brings us to the situation with Germany where the process of tempering theology with reality really has not made much progress.

I think the German situation puts most starkly the conflicting views and concepts as to the integration problem. The Germans, rooted in their view of integration theology and pointing to the fact that U.S. subsidiaries of German corporations pay 46 percent plus a 15 percent withholding tax, refused to consider granting the credit. Indeed, the German Parliament forbade the granting of the credit to foreign shareholders in its enabling legislation. A quite elegant piece of bootstrapping I think. The United States on the other hand, viewing it from our perspective, says that the 36 percent German tax is really a withholding tax. Thus, a comparable German company which distributes all its income has really zero tax and therefore the German controlled company bears a lower rate of tax than the U.S. controlled company. As a result, Germany has in effect financed its integration system by making up the revenue loss by increasing the tax on foreign-owned German companies. Therefore, the credit ought to be granted. I think it is a fair statement of the impasse in the current treaty negotiations.

There are some other factors which further complicate this problem. Whatever the theoretically right answer is I think the U.S. has to ask itself if it wants to encourage portfolio investment in German or other integration country corporations. If Germany is not a real problem, then look to Canada. Do we really want to insist that portfolio shareholders get the imputation credit? On the other hand, with respect to direct investors, it is clear that both the Treasury and the investors have an interest in getting the German rates down to approximately the U.S. rates, since presently Germany is a potential excess credit-generating country. One possibility there would be to go to a zero withholding rate by Germany. Just giving up reciprocity as a principle is a possibility although one that breaches our principle that we are entitled in fact to the imputation credit. On the other hand, Germany is arguing non-reciprocity in the other direction. It is that arguing because of its split rate and the famous foreign effect when you compare wholly-owned German companies with foreign controlled companies that distribute out and reinvest. They are entitled to non-reciprocal withholding rates only in the other direction. Ten percent of zero rather than zero and ten percent.

Where does this all leave us? I hope *Dave* [*Rosenbloom*] can tell us more after I have completed this summary. But I think, to summarize: Germany really puts in a very stark way the implications of the two ways of looking at integration; if the traditional U.S. position that we are entitled to get the imputation credit is correct, and if we apply OECD withholding rates, then Germany is really only going to be collecting 5 percent withholding tax on U.S. investments in Germany. That seems an improper division of the investment tax base. On the other hand, if you look at it from the U.S. point of view, Germany has indeed taken advantage of the fact that shareholders are not going to get the credit in structuring both the financial and international aspects of their integration system. How these theological principles will be worked out in this world of sinners I am not sure but I think they are very difficult questions.

## PANEL DISCUSSION

*Patrick.* Thank you *Hugh* [*Ault*]. If it is possible *David* [*Rosenbloom*] may like to make some comment on the general U.S. negotiating position; it being understood that the fact that the U.S. is now engaged in negotiations, poses some constraint on details.

### Variety in corporate-shareholder tax integration systems significant

*Rosenbloom.* I think Hugh's exposition was really superb. The only missing aspect was the treaty policy vis-a-vis a less developed country with an integration system. That does come up with more frequency than you might expect, since the old British system was in effect an integrated tax system.

We encounter that system in one form or another in a large number of former British colonies and what we do in that instance may be a little different than what we would do with respect to developed countries. In dealing with developing countries, we tend not to try to reduce source basis taxation below the credit limit. Another point here: there are variations in integrated taxes and to my way of thinking, the variations make a difference. For example, some countries have relatively low corporate rates, Denmark and Italy, for example. Some countries integrate relatively small portions of the corporate rate so that you can say that there remains a fairly substantial domestic tax on dividends at the shareholder level, Denmark for example. Some countries are concerned about funding the imputation credit. Canada allows the credit irrespective of whether it has collected any taxes at the corporate level. Italy is the same. There are other differences. For example, Canada grants a non-refundable credit. These variations on an integrated system do have an effect on an appropriate United States posture. I also believe that an integrated system, which is normally adopted to improve local investment in local corporations, has concomitantly the effect of disadvantaging foreign investment in local corporations. This is the other side of the coin, and it is inevitable. The negotiating question is what should we be asking to alleviate that disadvantage. In the United Kingdom context, as you know, we asked for refunds. Quite apart from the theology that *Hugh* [*Ault*] discussed, the refund mechanism is rather complex and, as anybody who has read the technical explanation of the U.K. treaty knows, it raises phenomenal issues regarding the foreign tax credit computations. Personally, at some point I would be willing to give up a little bit of the theoretical purity in favor of a result that achieves justice and simplicity, and that kind of thinking may lead toward dealing with withholding rates. Passing to Germany for a moment, I think Hugh's explanation of the situation therefore is really pretty accurate. There is really a difficulty in communicating. We are dealing with two extremely different world views.

*Muten.* To begin with, let me say that I speak here purely in a personal capacity, not representing the views of the International Monetary Fund. I shall mainly deal with issues concerning less developed countries.

### Some issues affecting less developed countries

One important issue is the extent to which a country like the United States establishes very precise rules on matters dealt with in Section 482 and 861 of the Code. By their way of applying these rules, the United States authorities put taxpayers dealing with them into a position where they really have to listen very carefully to what the Internal Revenue Service has to say. In doing so, these taxpayers may show correspondingly little interest in the attitudes of other competing tax administrations. If I were in charge of a tax department like *Bob Patrick's*, and forced to make a choice between making the U.S. Internal Revenue Service my enemy or getting in trouble with the Inland Revenue, say, in The Gambia, I would in all likelihood find it prudent to be friendly with the I.R.S. and care little about The Gambia.

This is at least what the less developed countries suspect. Therefore, they would very much like to have some feed-back from the big countries, since they feel that they cannot cope adequately with the problems arising.

They hope to get a favorable deal, not least through exchange of information and other administrative assistance, as a result of tax treaties. They are also interested in treaties as a way of assuring a positive result of their tax incentive measures by way of tax sparing. The performance of the U.S. has been disappointing to them, however. It is difficult for foreigners to understand the ratification procedure, under which the U.S. Senate unilaterally changes treaties that are the result of bargaining. Delays in ratification and reservations against important treaty provisions make the negotiation of tax treaties with the U.S. a rather frustrating experience.

A simple first line of defense for countries fearing the conflict of interest between their tax administrations and the Internal Revenue Service is the mandatory local incorporation. It might not stop at that, however. By making conditions too harsh on the capital-importing countries on issues such as arm's length pricing, cost allocation, and foreign tax credit — the latest developments in regard to the definition of creditable taxes has really been a very hard nut to crack for these countries — the industrialized countries, and notably the U.S., may force the less developed countries into a situation where they simply feel they have to give up. If they feel that it is beyond their capacity to administer the U.S. kind of a tax system, they might well go for something else. And the alternative might be less then appetizing for those who feel strongly about free enterprise, free trade and free movements of capital across borders.

I apologize for having been perhaps too critical in what I have said, but being the only non-American in this discussion I thought I should try to interpret some of those foreign voices I hear. Outside of this country, I feel more need than in this gathering for explaining and defending the U.S. position.

*Patrick.* I am sure that there are many of us who take it as very constructive criticism. We appreciate that. If not in rebuttal, at least in comment on this subject I will interject my observation that I do think some of the developed countries, including the United States, could adopt treaty rules to accommodate some requests of the developing countries that are not burdensome concessions and which are reasonable in accommodating the two systems. This is something that can be encouraged, not only for the United States, but for foreign countries as well. Perhaps there is a very real basis for bringing more and more countries into a reasonable tax system but I would like to have *David Rosenbloom* comment on what the LDCs are requesting, what he sees as the possibilities, not merely on the tax sparing issue or the incentive issue, but on the accommodation of some of the substantive rules.

*Rosenbloom.* We have been through a number of negotiations with developing countries fairly recently and there are a couple of things I am not sure are so apparent when you are dealing with the U.N. group, which we hear when you are dealing across the table from another particular foreign delegation.

There are political implications to the treaties between the United States and particular developing countries, and in some cases I think the political implications may be predominant in the minds of at least the other country. Whether it is possible to secure a treaty conforming to our guidelines — which I take it means pushing a lot of items of income into net basis taxation at source, and being relatively generous with net basis taxation at source — is a hard question. I think, generally speaking, we are moving in that general direction in the United States; but the ability to sell that approach to a particular developing country — which may feel much aggrieved and extremely mistrustful — is really a function of the background and personality and, indeed, the political standing of the people you are dealing with on the other side of the table.

That would not be true, I suspect, if I were representing the United Kingdom, or France, or Germany, but it is true since I am representing the United States. I think that developing countries behave in negotiations in ways — at least in my relatively brief experience — that are not always predictable on the basis of their participation in group discussions of policies. I think the reason for that is a different setting for the negotiations; the country can be extremely reasonable when it is dealing with broad guidelines, but when the question really is posed as to whether they are going to tax equipment leasing on a net basis of sorts, as opposed to imposing a stiff withholding tax, different considerations may result. I think there are serious implications to that decision which some treaty negotiators are not willing to accept.

In any event, we are spending a fair amount of time negotiations with developing countries. I quite agree that the procedure for having these treaties ratified on the Hill has not been altogether satisfactory in recent times. We are hoping that the treaties that we have there now can get ratified fairly early, not so much because the treaties are necessarily wonderful agreements in their own right, but because we have to start somewhere to broaden our treaty network with the developing world.

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*Jenks.* We are going to start with another panel session dealing with tax treaties. It is chaired by Dave Milton as moderator and includes Mordecai Feinberg and William Gifford. Later, we will have with us my colleague George Beatty, and Joseph Guttentag. At the outset the discussion will consider treaty procedures and the process of those procedures in the U.S. from the initiation to the ratification of treaties.

## TAX TREATY PROCEDURES

*David Milton*

*Milton.* Thank you, Tom. This does open a new subject for consideration. We had a small band of courageous people who agreed to try and do this, most of whom you see here at the table. *Marianne* [*Burge*] also has agreed to join us together with *Mort Feinberg*, our treaty negotiator, also known as the Associate Director of the Office of International Tax Affairs, and *Bill Gifford* of Wilmer, Cuttler & Pickering.

To introduce the subject and to attempt to set the stage for the panelists I would like to sketch some background color. In common with the range of topics that was discussed this morning, the historical procedures used for negotiation of tax treaties have become a matter of public and private concern over the last several years. Perhaps the most raucous voices heard were those of certain state tax administrators who, in my view, were caught with their hands in the cookie jar by the recently revised U.S.-U.K. income tax treaty as signed December 31, 1975, but who at this point appear to have made away with not just the cookies but also the jar.

Beyond that, there are many tax practitioners who have observed the increasing perplexity of the tax laws around the world and the increasing tendency of the U.S. and some other countries to reach beyond their borders. We have also seen an increasing tendency towards the use of the tax structure, and its application and interpretation, for specific political purposes. The inevitable result of this, of course, is an increased conflict of law and an increased possibility of multiple tax burdens and potential discrimination — as to the kinds of problems you heard about this morning.

The treaty system is a principal weapon in meshing conflicting laws and easing multiple taxation and discrimination. It must become even more significant than it has been. So taxpayers obviously are going to have a greater interest in the treaty process and so are those individuals, including members of Congress, who may feel that the Internal Revenue Code should not be altered by forces outside of the control of one or both of the Houses of Congress.

Congressional interest would not be new. There are a number of instances, both recent and past, where legislation or proposed legislation has included provisions dealing with executive branch agreements which have tax subjects.

Recent examples of that would be: (a) [Congressman] *Al Ullman's* modified integration proposal last year which would purport to give the Secretary of the Treasury authority to add a portion of a corporation's foreign tax credit to the shareholder account as a result of agreements with foreign government. These agreements were to be made subject to approval by both the House and the Senate. (b) Then there was the Social Security Act amendment referred to earlier which would provide authorization to the President to enter into agreements establishing totalization arrangements between the Social Security System of the United States and the social security systems of any foreign country.

There are two interesting aspects of the Social Security Act amendment. First, the Act describes certain mandatory and optional provisions for inclusion in the arrangements. In other words, Congress speaks to the content of the agreements in advance. Second, the mechanics provided are for the agreements to be transmitted to Congress whereby they will become effective after a stated time period unless either House adopts a resolution of disapproval of the agreement.

In the past we have had significant acts such as the Mutual Security Act of 1954 which provided that the President should accelerate a program of negotiating treaties for commerce and trade including tax treaties. The Foreign Assistance Act of 1961 is almost the same. Note that here Congress calls the document a "treaty", whereas in the current Acts we have referred to before, they are called "agreements".

You get the question of what is the applicable law. Are there fixed legal parameters that deal with the shape of the tax agreement process? Are these parameters mainly political?

The governing rules that I have found seem to be rather few in number. We have, of course, Article II Section 2, Clause 2 of the U.S. Constitution which reads, in effect, as you all probably know: I, the President, shall have power by and with the advice and consent of the Senate to make treaties provided two-thirds of the Senate is present and concur.

Now, the scope of those words "advice and consent" have not been fully explored by the courts, and to my knowledge the precise division of functions between the President and the Senate, and the treaty making process, has not really been debated fully in recent years. In looking at history, we find that from virtually the beginning the Senate seems to have been content in practice to have the Executive branch negotiate treaties, usually as an independent activity, and then present them to the Senate for consent. The "advice" side seems to have been generally inactive except for such things as the instructions to accelerate negotiations of treaties contained in the Mutual Security Act which we mentioned earlier, and in multilateral negotiations. There are a number of examples of what seem to be "advice" in the multilateral area: Congressional advisors appear to have attended the SALT discussions in sequence, while the Law of the Sea delegation had Congressional members, the International Energy Agency has also had Congressional attendance. But generally, the members of Congress are there as observers and not as delegates. However, there are some who feel that even this moves close to the Constitutional line.

As you all know the President also has the power to enter into other forms of international contracts either as the country's Chief Executive or otherwise under authority of law. Those that are made as Chief Executive do not require the consent of the Senate. So we have an interesting question as to whether an agreement made under one of the Constitutional sources of authority, for the President to make international agreements, could cover tax issues, rather than calling it a treaty. Now we have seen Congress do a similar thing in reverse in the social security area, calling the operative document an agreement rather than a treaty, and then imposing requirements beyond the Senate's advice and consent called for by treaties.

## Delegation of tax treaty negotiation function to the Treasury

Within the Executive branch, the President has delegated the treaty negotiation function to the State Department, as I understand it. State has, in effect, redelegated that power to Treasury as to tax treaties. Now those treaties that have some tax provisions, such as the treaties of friendship, commerce and navigation, were negotiated by State with Treasury input. So in theory it could be that Treasury would adhere to State's rules as to procedure.

The only State Department procedure which I have come across that pertains to this topic appeared in the July 24, 1974 revision of the Circular 175 procedure. [Foreign Affairs Manual, Volume 11 (Chapter 700) at sections 720.2D, 722.3, and 723.1.] Circular 175 is an internal State Department guideline and information manual on negotiation and signature of treaties and other international agreements. The procedure provides that as a general objective where in the opinion of the Secretary of State or his designee the circumstances permit, the public will be given an opportunity to comment on treaties and other international agreements. While this was adopted in 1974 its implementation has not been formalized to this time, to my knowledge. Under this procedure the request for authorization to negotiate a treaty is in a form of an action memorandum addressed to the Secretary. Among other things, the action memorandum is to indicate what arrangements are planned with respect to Congressional consultation and also to the opportunity for public comment on the treaty or agreement being negotiated. The officer who is responsible for negotiation is specifically charged with keeping in mind that the interest of the public is to be taken into account and where, in the opinion of the Secretary of State or his designee as the circumstances permit, the public is to be given an opportunity to comment. Of course, this does not say whether that should be a onetime opportunity or only at intervals. This procedure also establishes an objective that timely and appropriate consultation is to be had with Congressional leaders and committees on treaties and other international agreements. The officer responsible for negotiation is to keep the appropriate Congressional leaders and committees advised of the intention to negotiate significant new international agreements, consulted concerning these agreements, and informed of developments affecting them, especially if there is need for implementing legislation (which, of course, we would not find frequently in tax areas).

## Treasury practice as to tax treaty procedure negotiations

With this general background, what has been the past practice of Treasury as to treaty procedure negotiations. It generally has followed these lines: First of all, tax negotiation has assumed that the resulting document was a treaty and not an executive agreement. The procedure would be to announce the list of current and proposed negotiations and ask for comments. This list, as you all know, was not kept on an active basis and these comments could be a little old. Since the U.S. model treaty was developed it has been used as a base. In the background there was a handbook, I believe a classified handbook, which is not disclosed. As to consultation with Congress, The Treasury Department obviously has, to some extent, consulted with the Chairman and other members of the Senate Foreign Relations Committee in the course of negotiations. Treaty language was not known until the treaty was published at some point after signing, and then there were hearings before the Senate Foreign Relations Committee.

Recently, in response to suggestions and expressions of interest in opening treaty negotiations to public comment, including informal comment from IFA members, and obviously in line with his own views [Treasury representative] *David Rosenbloom* scheduled public review and comment sessions on four treaties. Italian, July, last year; Jamaica August, last year; Danish November, last year; Canadian December, 1978.

You have seen these reports, I am sure, and they were referred to earlier, but to summarize very briefly for those who have not read the reports, and who were not there, the meetings were informal and no transcript was made. *David Rosenbloom* and several members of the Treasury negotiating team were present. There were also IRS representatives present at the Canadian treaty session and at the Danish session. I am not aware of their being at the others. Treasury summarized the major issues and the state of the negotiations. The participants could raise questions and make comments. Apparently you could turn in papers, but there was no formal paper presented at the session by anyone, to my knowledge.

These latest events would seem to be of great potential significance in the treaty process and we would like to start talking about them. *Mort* [*Feinberg*] was at three of the four meetings on behalf of Treasury and we would like him to review them from the Treasury side pointing out what the ground rules were for the meetings. I believe Treasury viewed the meeting as a success.

## PANEL DISCUSSION

### Ground rules for tax treaty meetings

*Feinberg.* Thank you. A word about the ground rules. First, in each instance, we discussed with the partner our plans to do this and in every case they agreed that this was an appropriate procedure. We made it clear both to our partners and to the participants in the meetings that we were speaking only for the U.S., not for the treaty partners, and that what we discussed would be the U.S. negotiating positions given the nature of the two tax systems and the nature of the problems we have to deal with, and the conceptual approaches we were taking to some of these problems — they were not necessarily agreed solutions. We were not discussing the negotiating position of the other country or where there were final agreements; we were not necessarily indicating what those agreements were. It was an effort to indicate to the public where we were coming from in these negotiations. I think we found them very useful. I think I speak for all of us at Treasury who have been involved. It provided us with knowledge of some of the specific issues that were of concern to the taxpayers that we may not have been aware of, or areas where the standard or model approaches we have taken in the past may not precisely deal with the problems that were raised in that particular treaty and that particular relationship. In a number of cases we did receive proposals for resolutions for some of those issues that we may not ourselves have thought of or were able to think of.

Along the same lines attention was called to problems that would arise in meshing two particular tax systems that may not be able to be dealt with in a model treaty in a standardized approach. It is equally important that we were involving to a much greater extent the public in the process of negotiating a treaty. I think in addition we generated considerable interest outside of the meetings, and as a result of the meetings, additional representations from the public with respect to the problem that they face. I think that we do intend to continue these meetings, where appropriate, and we appreciate the input that we have received.

*Milton.* Mort, do you intend to continue them? These were done at an intermediate state of the process of negotiations as distinct from at the beginning. Do you intend to continue them in that intermediate stage or also do this kind of things for openers?

*Feinberg.* I think it is most appropriate to do this at the stage where we have been doing it. That is at the point where we have achieved probably our greatest understanding of the issues and we have identified all the issues at that point and that is the time we need as much help as we can get. At the beginning, what we have practised for a number of years now, is issuing an announcement that negotiations will be held and soliciting comments. At the early stages this is the more appropriate way to deal with it. We have a clear picture of where we intend to go and what issues we may not be able to resolve ourselves. It is a better time to involve the public in this kind of a form.

*Burge.* What kind of response does the announcement usually elicit, Mort? A hundred letters or five letters?

*Feinberg.* There is no way to generalize. In some, very very few. Are we talking about Canada or Bangladesh? It varies tremendously.

*Milton.* Marianne, you were at all four of these public meetings as I understand it. What is your view of their worth, looked at from the taxpayer's side?

*Burge.* From the taxpayer's side I would say I am wholeheartedly in favor of the public briefing procedure. And certainly for the advisers to the taxpayer. The public briefings are a one hundred percent improvement over the previous method of obtaining information from somebody in Washington who heard it from somebody in Washington, who heard it from somebody in Washington. This is a tremendous improvement and I am wholly in favor of continuing the procedure and also having IFA report on the proceedings to its members and giving the report as wide a circulation as possible and in other publications, and to encourage more taxpayers and their advisers to participate.

### Advantages of public briefings

I think the specific advantages are that the taxpayers can find out at a stage before the treaty is signed and almost fixed in stone as to what the issues are and they can then review their own operations and comment on the effect of that proposed treaty to the Treasury. The taxpayers and their advisers also can learn for the first time what Treasury policies lie behind some of the treaty provisions. It is difficult to know what the policy is behind some of the language in the treaties. So there is a cumulative educational effect, I think, of the public briefings to those who attended all four so far. I think it is very important to the taxpayers. Treaty issues are something of a mystery to most people and they are different and a part of the international tax law that a lot of people are just getting involved with. So it is very important that taxpayers and their advisers should know what is in store for them in the treaty area because if the taxpayers are not kept informed of what is being planned in the treaty area they may find out that the costs and the problems of the treaty might even exceed the benefits.

I say this because I think we may be getting into deep water in some of the treaties in trying to create perfect accommodations between two tax systems and the results may be that we end up having something that's so abstract that it is unworkable, in the effort to try and be very fair and very perfect. So I think we end up not being able to complete treaties at all. Taxpayers may not as yet respond as you might have hoped to the Treasury, and I suppose you could see why that might be the case so far. I suppose the only treaty of major interest that we have had a briefing on so far has been Canada. The public session was very well attended. I think you will generally find that taxpayers will not respond unless they see something important or immediate for them in their own operations in a certain country because there certainly isn't time for everybody to keep informed on everything.

Also, the briefing procedures are new. It is possible that people are not really aware of them and that the meetings are being held. The briefings were a bit one-sided. I suppose a briefing is intended to be for information giving, and not much time was left for audience participation. The issues were also discussed somewhat in the abstract. Some of us found it a bit hard to follow the policy concepts. I found that this grew easier from one meeting to the next as one came to recognize the policy issues that were being discussed. So I think it is very important that one attend them. I think that even with a limited discussion we found that some comments and information that was of use to the Treasury came out of them.

*Panelist.* Marianne, I do not want to interrupt, but could you tell us whether the majority of the people there were there for education as distinct from having an interest in a given country?

*Burge.* I think most of the people there were there because they had an interest in the country or a particular industry. There were certain industry representatives there.

*Panelist.* If I may, I think it was particularly clear in the Canadian meeting that a number of people were there to hear about one particular article, one particular kind of issue. I think that may well be why there was so much larger crowd at the Canadian meeting because there were many more people who had interest in particular issues rather than in the treaty process in general.

*Burge.* I think it is a bit too early perhaps to say whether the comments the taxpayers have made are going to be taken in account in the negotiations. I do not know how you feel about that, Mort.

*Feinberg.* In general, sure they will be taken into account. We will consider them; whether we consider them appropriate or whether in fact there is anything we can do about it in a give and take negotiation is another matter.

*Milton.* We did not make any opening comment about taking questions but I do not see any reason why we should not take any.

*Question from audience.* Is there any follow-up by people asking questions and giving thoughts to you?

*Feinberg.* As I said before I think these meetings generated a great deal of additional interest and submissions and meetings and conversations that we would not have had otherwise.

*Audience comment.* I was wondering if there will be an opportunity for the partners that are negotiating the treaty to have their own advisers and representatives participate and give their own position at the briefing. Does this occur in fact? For instance could they hire U.S. tax counsel to participate in the briefing?

*Feinberg.* Yes, they are open meetings. Anyone can attend. We have advised the other government, in each case, as to when the meetings were and there have been at least embassy representatives. In the Canadian case there were people from Canada who came down and I do not recall whether they participated actively or not, but they were certainly free to.

*Milton.* Let us pursue this question of openness from another side. I know my understanding is that the business community in the OECD has indicated that they would like further openness in treaty negotiations from the side of their governments. *Mort* [*Feinberg*], do you think that from your experience in dealing with the treaty partners that if there is increased openness on the U.S. side that that will foster the same kind of thing with other governments with respect to their taxpayers?

*Feinberg.* That is hard to say. I think it will inevitably put some pressure on them, at least those in countries where they are aware of what is going on here. There undoubtedly would be calls for similar meetings at home in their countries. Whether they can feel they can respond to that kind of pressure I really cannot say. I have the impression that without limited openness they tend to be much more open in these matters than most other countries and my guess is that relatively few will pick up the idea. I mentioned before that there are now more long standing practices of issuing announcements before the meetings. I believe we were the first to do that. Several other countries have picked up that idea and have found it profitable.

*Milton.* There are some countries that I know of, but I cannot of course speak for many of them, that do circularize their trade organizations and such at the commencement of [treaty] negotiations to get them into the picture. The U.K. does that for instance. They send a notice around to the Confederation of British Industries and I think the U.K. branch of the International Chamber, and accounting groups, and others. There is someone doing these things.

And speaking of trade groups, in conversations that *Bob Patrick* and I had about a year ago with *David Rosenbloom* a suggestion that was tossed out for consideration involved the use of the IFA U.S. branch as a private clearing house to identify taxpayers' interest and to try to get a focus on problems by countries. *Bill* [*Gifford*], what do you think about that from a practical point of view? Are there a lot of legal problems and such involved?

## IFA as a private clearing house for international tax problems

*Gifford.* Without advocating for or against the idea, I would identify one of the problems as when in the process IFA would play a role as a private clearing house. If it is before negotiations are undertaken, or when the Treasury's initial announcements come out, I suppose that it could be a fairly free and open forum for exchange of ideas. As the issues get more specific and narrowed in the course of negotiations, I think it gets more difficult for taxpayers to participate, whether through a trade association or other group. To the extent that effective participation consists in sharing empirical data, rather than technical legal suggestions as to what the treaty ought to contain, it of course becomes more difficult. To pick up on the specific question, about the legal issues that come up, the commercial secrecy questions come to mind immediately, but I do not find that area in itself too troublesome. Taxpayers would be largely self-selecting, and they simply will not participate when the matters involve extreme confidentiality.

*Jenks.* Well, we have certainly had a summarization of differing views on this topic. Thanks to all of you. It is now time to pass on to other things.

## Competent authority procedure

I would now like to ask *George Beatty* to offer some ideas of his about the competent authority mechanism.

*Beatty.* Thanks, Tom. We are fortunate enough to have *Dave Reizes* of OIO [Office of International Operations] here with us this afternoon to participate in the discussion.

As you know, one of the principal functions of the U.S. competent authority program is to deal with cases involving the section 482 requirements of our Code and the equivalent rules of other developed countries. The interplay between their transfer price rules and ours necessitates some mechanism to avoid double taxation of the same income.

It is difficult to assess the qualitative and quantitative effects of our present approach to competent authority proceedings. Perhaps the best success, not surprisingly, is the experience we have had with the Canadian program — a program that is, in many respects, a pioneering one. Of course, we have had competent authority proceedings with Canada for some years, but certainly not on the scale of the modern program which dates from the early 70's.

To me, one of the threshold problems with competent authority cases is deciding whether or not competent authority relief should be invoked in the first place.

Initially, the reaction of most people is that if double taxation has been proposed as a result of conflicting adjustments in different countries, the obvious solution is to initiate competent authority proceedings and let the two governments battle it out. But there are some threshold considerations that may in many instances make it undesirable to do that. One that I think is most often encountered in practice is the notion that cases can be more expeditiously settled on audit if the taxpayer is willing to forego competent authority rights as part of what amounts to a package settlement with either the agent, or in some cases, the appellate conferee. This, in effect, uses the availability of competent authority proceedings as a negotiating weapon or at least a consideration to be weighted in settling the case. The argument is that because relief is available, the taxpayer should get some benefit for giving up his rights to invoke formal competent authority proceedings. This happens not only here, but certainly abroad as well. To a certain extent I think it can be viewed as undermining the integrity of the competent authority relief mechanism. On the other hand, by definition the end result must be one that is satisfactory to the taxpayer. For a variety of reasons — the aggravation, the expense, the time and effort involved — the taxpayer may be willing to unilaterally absorb a certain amount of double taxation in order to get its case closed.

On other factor that enters into the decision in a number of cases is the threat or possibility, either real or imagined, of retaliation in the foreign jurisdiction if the taxpayer invokes competent authority proceedings. *Dave* [*Reizes*], do you get any feel from your experience to date as to whether the threat of retaliation that is often talked about is real or not?

### Retaliation by foreign tax authorities

*Reizes.* I have a feeling that many taxpayers are worried about retaliation and have not sought competent authority assistance just because of those fears, real or imagined. As of today, we have looked into many cases. Wherever there is an allegation of retaliation, we get into it very quickly and very strongly. We have not yet run across a single case of retaliation. There are two potential cases we are looking into now. I sent a group manager and one of my team leader senior analysts over to Europe yesterday and they should be meeting this afternoon, as a matter of fact. The meetings will continue on through next week. Our initial investigations of the cases they are working on disclose that a negotiating factor is involved. Here in this country there is often a question whether a taxpayer should come and seek competent authority. I am sure most of you have handled difficult complex examinations, gotten in at the audit level, and very often, once a case has been developed and the issues have been pretty well defined, the International Examiner, the agent and the case manager are seeking agreement on a case in which you are not really that far apart. It is very similar to the negotiation or settlement of a law suit. You have all your points in issue, all your litigating positions, you have all the auditor's issues that have been raised. Some are pretty solid; some might be weak; some have a little bit of water in them, but are basically very arguable. When you sit down to discuss those issues and determine whether or not you are going to agree, I am sure one party or the other starts trading off. Basically one party says, "these are the cards we have on the table; if you will agree to these three points, we will be willing to wipe out the other one or two points, or whatever. But if you are going to go forward, and you are going to contest it, we are going with the whole ball of wax on all of the issues."

I think that some of the fears of retaliation are really a réflection by foreign tax advisors at the foreign office of some of the accounting firms or the law firms. Those advisers are saying that the foreign revenue officials have so many issues, so many points that they have developed in their examination, and if the case is settled, if it is agreed, then some of those issues or points are going to be dropped. If it is not agreed and it goes to competent authority and is subject to review, the officials are going to submit a very complete and full report. That explains a good portion of it. What it does not explain is, where there has been an examination or there has been an agreement in a foreign country, and then at a later time, because our audit cycle is slower than in most other countries and a little bit more complete, we start proposing an adjustment. At that point the taxpayer wants to go to the foreign competent authority or a foreign revenue authority to get a refund, or credit. We then hear that there are fears of retaliation because if the foreign country has to give a correlative adjustment, the company better look out in its succeeding years or it is going to be dealt with harshly. I think those are the fears we are particularly concerned with, but we have not yet hit one case where they have been justified.

*Beatty.* But if I understand your comment, you do in fact investigate and follow up on any serious assertion that retaliation has in fact been threatened.

*Reizes.* Yes. It would be unthinkable for us to allow it to continue.

*Question from audience.* What happens if the taxpayer believes that a foreign government will come up with a different type of interpretation and in effect will create a tax liability which did not exist?

*Reizes.* Let me see if I understand your question. You are saying, in other words, we have a proposed adjustment. A taxpayer hesitates ...

*Comment from audience.* What I am talking about is that under the existing treaties is it not a question of interpretation of the treaty? I do not believe we distinguish competent authority cases we have which are interpretations on issues when we are dealing directly with foreign governments, in contrast as to how to interpret them, for example, in terms of our view of whether specific prices are reasonable. When you get a question of interpretation, where can you discuss it with the taxpayer? And what about retaliation?

*Reizes.* It is part of the competent authority's role to be interpretative. The U.S. competent authority is the Assistant Commissioner of Compliance. In the interpretative area the Assistant Commissioner of Compliance acts with the concurrence of the Assistant Commissioner Technical. At the present time, we have 33 non-allocation cases of which, let us say, maybe 10 of them deal with interpretations, the treaty language or entitlement of treaty benefits, things of that nature. Where there is a dispute between our interpretation and a foreign country's interpretation of the treaty language — who the provision was meant to cover, whether there is qualification for particular benefits, what is meant by permanent establishment, whatever it may be — of course we will entertain it. The question is retaliation. What I cannot really discern from your question is, how would this come about in a retaliation setting? We handle cases involving conflicting interpretation. We are happy to; that is our job.

*Reizes.* Well, there are cases in which there is an awful lot of coordination and consultation with International Tax Counsel in Treasury. There are cases where we find that the foreign competent authority is proposing to treat a class of taxpayers in a particular way. If they are going to be interpreting the treaty language in administering their laws in a way that we do not think is appropriate, we are very interested in that.

I think the United States competent authority has an affirmative duty to represent its taxpayers. The question really is, depending upon the particular case, at which point is it appropriate for the competent authorities we are talking about — the administrative competent authority in negotiation of cases and controversies, and interpretations — to get involved, versus at which point is it a question of negotiation between International Tax Counsel and the foreign government. In this country, of course, we do have that separation between policy and administration. It is not necessarily the case in most other countries. So it is a difficult issue, but I think we would see an affirmative obligation to do something about that.

*Comment from audience.* When you reach an interpretation agreement with the other country, do you ever publish the results?

*Reizes.* Yes.

*Panelist.* Dave, was the recent ruling with respect to the interpretation of the Japanese Treaty and the application of sections 861 and 482 to a U.S. permanent establishment of the Japanese company, was that agreed with the Japanese competent authorities or that ruling ...?

*Beatty.* I promised Dave that we would not get into a discussion of that problem because of its current status.

*Comment from audience.* At least that is an example of the kind of issue you are talking about, I think, and where there has been a question of interpretation, the interpretation was made and it was published.

*Comment from audience.* In what percent of the cases brought to the U.S. competent authority by U.S. taxpayers is the competent authority relief denied either by the U.S. or the foreign government?

### Competent authority cases accepted

*Reizes.* The figures I have are of cases that have been accepted for competent authority consideration, for negotiation. Of those figures, in allocation cases we are talking about 86 percent full relief and an additional 14 percent partial relief. In most cases relief was given. What is not included in those figures is the number of cases that have come in where we did not think that competent authority consideration was warranted. We did not find there was double taxation; we found in certain cases taxpayers may have come in without clean hands for any number of reasons; we have found that in certain cases, the statute of limitations had expired. This was a recurring issue, where the statute of limitations had expired previously and the taxpayers had been on notice. The statute expired again, there was nothing we could do as far as obtaining a correlative adjustment from our treaty partner, and the taxpayers came in just after the statute expired. So we turned them down the second time around.

There are several questions involved here, and cases which we felt were inappropriate for consideration are not included in these figures. There have been a number of those cases, I do not know exactly how many, but in the last five years you are maybe talking about 8 or 9 cases.

When a case is submitted for competent authority consideration, it can either be accepted or rejected. If it is rejected that decision is appealable under an appeals procedure. Rev. Proc. 77-16 [77-1 C.B. 573], or Rev. Proc. 70-18 [1970-2 C.B. 493]. There are cases right now in appeal on that very issue — whether a case is appropriate for competent authority consideration. Competent authority consideration, and the efforts the competent authority goes through once a case is accepted, can range from the advocacy of the taxpayer's position with the foreign government to the other side of the coin. In other words, to help the taxpayer secure relief via a correlative adjustment, or sometimes the relief that is given is unilateral, that is, *we* will give relief. Sometimes, we might find the case is not developed substantially enough so that we could carry a burden of proof with the foreign government and persuade them to make a correlative adjustment. In such a case we may well withdraw an issue. We might find various reasons why we will give relief unilaterally under this bilateral procedure. Sometimes we split the issues, but that is once the case is accepted.

*Question from audience.* Did you say that competent authority cases were published?

*Reizes.* No.

*Comment from audience.* Oh. Because I was going to say I had never seen one.

### Competent authority cases are not published

*Reizes.* Well, that's good! (laughter) I really hate to anticipate some of the things *George* [*Beatty*] wants to talk about, but we are dealing here with questions of privacy and disclosure, and the competent authority plays a very different role than the Revenue Service in general. Officially it advocates *for* the U.S. taxpayer. There has to be a somewhat confidential relationship where taxpayers can feel free to disclose to the competent authority facts that they would not even disclose in arguments with an examining agent. If we have to go forward and argue *your* case to the foreign government, we have to know all the facts and we cannot be surprised. That is one of the reasons for our announced policy that we do not raise affirmative issues. If a company, for example, has been examined and that examination is complete, we are not going to raise an affirmative issue when the case is under competent authority jurisdiction so long as there's no fraud or misrepresentation. We will just argue what we think to be the good solid points on behalf of the taxpayer. And this confidential relationship obviously is going to get into business operations and data about the company that cannot be disclosed.

Another factor that really is not a matter for publication is what goes on in the negotiations between the governments. We normally do not go over to negotiate a particular case. Very often we will have a group of ten cases which will be negotiated together, and there are a number of trade-offs that can occur. And so, really very often, at least in allocation areas as opposed to the treaty benefit non-allocation entitlement type cases, the competent authority decision cannot be a precedent for a later case. We would not want to publish and give people the wrong opinion.

### Transfer pricing and the customs impact

*Beatty.* In addition to the whole problem of disclosure of trade secrets or sensitive information, the possibility of encouraging joint audits, and other exchanges of information which *Joe* [*Guttentag*] will touch on later, there is one other factor which I think often influences people in deciding whether or not to go to competent authority. In pricing cases, the potential customs impact can clearly be significant. As you know, *Robert M. Brittingham* [66 T.C. 373 (1976) affirmed —— F.2d —— (5th Cir. 1979)] refers to the relationship between customs duties and proper transfer pricing in section 482 cases. There was also a recent situation where what started out as an anti-dumping investigation in this country turned into a section 482 case with some of the files and data that had been made available to the customs people being turned over to the tax authorities. I think that there is going to be an increasing relationship between customs considerations and pricing considerations, particularly in foreign countries where the two are administered by the same governmental agency, with the result that there is more likely to be cross checking of data.

## Competent authority procedure and timing requirements

There are a whole variety of procedural questions that arise if the decision is made to seek competent authority relief, but the most obvious is the timing requirement for invoking the procedures. There have been statements made in the past to the effect that nothing need be done until the U.S. taxpayer receives the standard form letter from OIO advising the taxpayer that section 482 adjustments are under consideration. I think Dave's feeling, if I understand it correctly, is that it is not always possible to wait until that point, if by so doing the taxpayer is going to let an applicable statute of limitations expire in the foreign country that would be affected by the potential adjustment. Am I right Dave, that in a case where the past history and nature of the audit clearly indicate that a section 482 adjustment is under consideration, you would expect the taxpayer to take protective action abroad even though a form letter had not been officially delivered by the IRS?

*Reizes.* Yes. There was a lot of confusion, about a year and a half ago, as to exactly when the taxpayer was on notice, that is, when was the taxpayer required to take this protective action. There was a statement made. I think half of that statement was, "if the taxpayer is not given the form letter and the statute of limitation expires, the U.S. competent authority would unilaterally withdraw a proposed adjustment." But the other half of the statement, was that the time a taxpayer is on notice — the time that his entitlement to relief is considered to have expired — is when he *knew or should have known* that he had to take protective action in the other countries!

Every situation is different. In some cases there is a recurring examination with the same issues recurring, and the taxpayer already knows that this issue is going to be examined again, the same facts are going to be found. He can protect himself in the other country. What we in the Service find very difficult to determine is, when is the proper time to give the pattern letter in order to be fair to taxpayers? I think a while ago it was being given at the point that the issues became pretty firmed up. We do not think it is proper to unnecessarily have the international examiner walk in and say he has arrived and hand you a pattern letter, particularly when you have a client or you have a company that has subsidiaries all over the world. If you have to start rushing out and keeping the statutes open without knowing what adjustments may be involved, certainly you are going to get into trouble. We realize that. What we are really trying to do is find an appropriate time when taxpayers can be reasonably sure of what the potential adjustments are and so be able to make a business decision as to which procedural impediments in foreign countries they can stop from being interposed against future relief. That is certainly before the 30-day letter and it is probably in an overwhelming number of cases sometime after the opening conference. But we really have not yet firmed this up and we go on a case by case basis.

## Tax treaties and statute of limitations

*Beatty.* As I am sure most of you know, the statute of limitations problem falls into three distinct categories. In our most recent treaties — the Polish treaty, the Egyptian proposed treaty, the pending Israeli treaty, and in our model treaty — there is a provision stating explicitly that any competent authority relief that is granted shall be reflected in an appropriate adjustment notwithstanding any procedural bar in either of the countries involved. There is no statute of limitations problem when you are operating under a treaty of that sort.

In a second group of treaties involving countries such as Finland, France, Iceland, Japan, Korea, Netherlands, Norway, Rumania, Russia and Trinidad, there is a provision in the treaty stating that if the adjustment is agreed to be made, it "shall" be made. The U.S. interpretation of those treaties has generally been that they were intended to override any local statute of limitations problems. However, in at least two instances involving Germany and the U.K. where that type of treaty is presently in effect, there is disagreement on the other side of the fence as to the meaning of those provisions. This is particularly true in the U.K., although the competent authorities have been able in one fashion or another to solve most of the problems that have arisen to date. The official U.K. position is that the statute of limitations may not be waived under the existing treaty and indeed under the new one that has been negotiated. As a result, anybody who has a U.K. problem should certainly proceed under the assumption that the U.K. statute can and will operate as a barrier if you do not institute competent authority proceedings in timely fashion. I would hope that in the near future the IRS would issue some sort of release warning people of this because there is a published ruling, Rev. Rul. 72-437 [1972-2 C.B. 660], that catalogues the treaties of this sort and indicates that the statute of limitations is not a problem.

The third category of cases involves our older treaties which contain no provision at all with respect to the statute of limitations. In those instances, if relief is not sought in timely fashion, the statute operates as an absolute bar. Canada is one outstanding example. There is simply no way that the competent authority here has been able to persuade the Canadians to override their statute in one fashion or another. In Australia, where the treaty is in the same form, the problem has been solved through what has been called telescoping the adjustment, by having the Australians reflect adjustments that really relate to prior years in a current year which is open. This can raise some very difficult foreign tax credit questions that we will touch on later if we have got time.

## Guidelines for competent authority procedures in Canada and the United States

On the content for a claim for relief we have got explicit guidelines for two countries in the world. Rev. Proc. 70-18 [1970-2 C.B. 493] provides the procedures for U.S. taxpayers involved in allocation cases. The only other country to publish procedures is Canada which has issued information circular 71-17 spelling out the procedures to follow there. I think it is interesting and encouraging that an explicit provision has been added as Article 25-5 of the U.N. model treaty in effect directing or strongly encouraging competent authorities to develop specific procedures implementing their competent authority programs by spelling out in some detail the route that taxpayers are supposed to follow in invoking the procedures.

I think the heart of the whole competent authority program is the jurisdictional aspect of it, because the effectiveness of the program depends on the willingness of the authorities in the affected countries to deal with issues as they are presented. A number of questions in this area arise. For example, where you have a double inclusion in income or disallowance of a deduction which results not from different factual treatment of the same item, but rather from differences in the internal law of the two countries involved, should the competent authority try to deal with that type of case? Does the answer depend on whether or not the treaty explicitly gives the competent authority directions to deal with problems arising, for example, as a result of different sourcing rules? Or should it be within the broad general discretion of the competent authority to deal with those cases even though there is no explicit direction? Should the U.S. negotiate questions that involve just earning and profit matters, as opposed to allocations of taxable income or expense? Should the U.S. negotiate on section 861 adjustments which, depending on the circumstances, may have the same effect for somebody who is in limitation under section 904(a) as a disallowance of the deduction for the amount that is being allocated to foreign source income under the section 861 rules? How should the competent authority deal with de minimis cases where the amount involved is relatively small with respect to any one country but in the aggregate is perhaps significant? For example, a pricing adjustment on export sales by a U.S. parent to subsidiaries in 25 different treaty countries may involve a relatively small amount with respect to each one of those countries viewed separately, but in the aggregate it may be significant enough so that the revenue agent is properly raising the issue in the first instance. To what extent should the competent authority exercise its discretionary jurisdiction if there are overtones of negligence or, worse yet, actual fraud in the case? All of these, it seems to me, are difficult and important questions. *David Rosenbloom* is in the back and I would appreciate, Dave, any thoughts that you have on what the proper scope of competent authority proceedings ought to be.

*Rosenbloom.* George, only in non-allocation cases does the issue arise. I think in the allocation cases the question of what a competent authority can or cannot do is really not currently creating much of a problem. Maybe one way to interpret a treaty for purpose of the competent authority function in re-allocation cases is to take much the same position that we would in regard to ruling requests under the Internal Revenue Code. I think that we are really in the first stages of asking ourselves what the appropriate competent authority role is, and I think that is a major treaty problem.

*Beatty.* In addition to the competent authority relief that is available under treaties we have also been developing a mechanism to deal with allocation issues arising in the possessions. Dave, am I right that we have a formal agreement with the Virgin Islands and that we are working on one with Puerto Rico?

**Allocation issues in connection with U.S. possessions**

*Reizes.* We have an agreement with the Virgin Islands. We talk about it somewhat procedurally in the nature of the treaties. But it is wholly different than the treaties. The basic document is modeled the same way that the Internal Revenue Service has agreements with all of our state taxing authorities, the cooperation and coordination agreements for exchanging information, verifying return data, programs to assist one another in the administration of the laws. Now of course, the Virgin Islands is in a unique position of having people who are dealing with essentially the same taxing document. Under Article 28-A of the Revised Organic Act of the Virgin Islands, U.S. citizens and U.S. taxpayers generally must pay taxes under our tax system to the United States where their income is sourced. But they are excused from filing with the United States and paying to the extent that an individual is an inhabitant of the Virgin Islands and they file and pay with Virgin Islands. There is a lot of interplay between corporate taxation, the Virgin Islands industrial incentive act, and the tax benefits that are granted to business taxpayers under the Code. And we do coordinate our taxes. In as much as we are applying the same basic legal document – the Internal Revenue Code of 1954 as amended and as interpreted up to the current date – it is fairly important that we deal consistently with it. So, under this cooperation and coordination agreement we have a mutual agreement procedure very much like the treaty procedure that we are talking about that handles just the same type of questions as far as allocation facts, taxation facts, jurisdictional facts and questions of residence are concerned. If we have the same law, and there should be only one set of facts, we should arrive at the same result. We are attempting to resolve problems of double taxation in those cases. That is an easy situation.

Now you bring up Puerto Rico. We have been negotiating with the Secretary of the Treasury of Puerto Rico. We have a basic negotiating document, identical pretty much to the Virgin Islands document. The difficulty here, and one of the reasons why we do not have yet anything implemented, is that we are not dealing with an identical code; we are dealing with the Puerto Rico Code (which is taken from the 1939 Internal Revenue Code). There are possible differences of law and interpretation. While we are looking forward, hopefully, to something in the near future, we do not have anything final with Puerto Rico yet.[6]

*Beatty.* Let me move on at this juncture to a brief consideration of some of the negotiating policies. There are a number of situations where an issue which arises in both treaty countries and non-treaty countries will be disposed of satisfactorily in competent authority proceedings. The question arises at to whether that disposition should be given effect by the IRS in dealing with section 482 adjustments in the non-treaty countries. My understanding of current policy is that it is not given effect, because the result reached in competent authority treaty discussions represents a compromise of competing positions; it represents one of the benefits that is attributable to the existence of the treaty and you would be denegating the status of the treaty if you applied the same result and gave similar relief in the non-treaty context. Is that essentially right?

**No competent authority procedure in non-treaty situations**

*Reizes.* The competent authority has its basic power deriving from the treaty. The competent authority, which is a centralized function, has no authority to tell the district what to do with the non-treaty case. The second factor to consider is the negotiating position of Treasury. As they have represented it in the past, to the extent that a non-treaty country can obtain for taxpayers and companies having tax relationships with it the same benefits that treaty countries can obtain, then there is no advantage to having a tax treaty. We defeat our system.

*Beatty.* In cases where an agreement has been reached and provision has been made for repatriation of the amount of section 482 allocation adjustments, am I right that under the typical competent authority closing agreement there will be no interest charged on the amount of that repatriation in contrast to the procedure that is used in non-competent authority cases where a Rev. Proc. 65-17 [1965-1 C.B. 833] receivable is created and interest is charged?

*Reizes.* Almost every one of our closing agreements providing for repatriation has allowed the U.S. taxpayer to forego interest.

*Jenks.* George, I think time is running out on us. I would like to thank you on behalf of the group for a very fine presentation.

* * *

*Joe Guttentag* will be our next speaker. He will comment on exchange of information under treaties.

6. IR 2123 released April 25, 1979, sets forth the U.S.-Puerto Rican mutual agreement procedure which was adopted after this conference.

# EXCHANGE OF INFORMATION UNDER TAX TREATIES

*Joseph H. Guttentag*

This subject has moved from a position of being completely ignored to one of extreme importance to tax administrators, taxpayers and their advisors within recent years. Provisions for exchange of information in tax conventions have long existed and in substantially the same form as they appear in the current Article 26 of the OECD draft, and in the U.S. model treaty. In the past technical explanations and the Senate reports listed exchange of information as one of the standard tax convention administrative provisions and with some exceptions paid little attention to what it meant or how it was administered.

Why the recent interest in exchange of information? First, it appears that tax administrators are becoming increasingly concerned about the tax consequence of transactions extending beyond their national boundaries. This concern exists regardless of whether the tax system uses a territorial or worldwide approach. Information available only outside the country of residence or home country of the taxpayer may be necessary in order to determine whether the taxpayer is paying his appropriate share of taxes on income earned within the home country or entitlement to tax credit. Secondly, there are problems of tax evasion which can only be detected and determined with information obtainable outside the home country. There is also increasing concern over the use of tax havens. Through information exchange tax administrators, even though not able to obtain information directly from tax haven countries can through the use of triangulation zero in on transactions and determine the extent of income which may be sheltered overseas.

The United States has always supported the broadest type of information exchange, with certain caveats which we will mention and which are reflected in the current U.S. model convention. It is very natural for the United States to do so. The United States has an extremely extensive taxing jurisdiction and needs all of the information it can obtain. The U.S. also has the ability to use such information effectively. It is also in the interest of the United States to provide information to other tax authorities to enable them to enforce their tax laws. From a competitive point of view, the multi-national resident in a country which has low enforcement may very well have a competitive advantage over a competitor located in a strict enforcement jurisdiction. Accordingly, to the extent that the United States is able to provide information which assists countries in a stricter and more equitable enforcement of their tax laws, the competitive position of the U.S.-based multinational is enhanced.

On the other hand, to the extent that the information exchange system provides assistance to the United States for even stricter enforcement of its extensive taxing jurisdiction, the competitive position of the U.S. companies may be weakened. We are dealing exclusively, at least in the case of the United States, with bilateral provisions for information exchange. Accordingly, more equitable tax enforcement, meaning probably stricter tax enforcement by the United States and its treaty partner, country "X", may provide a more equitable competitive position between companies resident in those two countries, but may create a greater competitive disadvantage for both companies vis-a-vis a company located in country "Y", which has no tax treaties with either the United States or country "X". The United States has more information available and better means to obtain it than any other country in what we used to call the free world.

The imbalance in providing information and the use of the information is probably most viable with respect to the developing countries. The subject of information exchange was one of great concern in the development of the draft model convention for treaties between developed and developing countries. The developing countries were quite concerned, and rightfully so, that a treaty which was imbalanced as far as the economic consequences, the flow of investment and the flow of trade, had to be balanced and protected on the fiscal side by enabling tax administrators in developing countries to ensure, to the extent possible, that they were receiving the appropriate share of revenue from income earned by residents of their treaty partner.

**LDC's fear imbalance in the provision of information**

Furthermore LDC's interested in broader taxing jurisdiction at source thus require more available information. The lack of sophistication or the ability to enforce effectively the tax laws of the developing countries made these information exchange issues of much greater significance than in treaties between developed countries. There are still relatively few treaties in effect between the developed and developing countries and it will be some time before we see the results of the efforts of the group of U.N. experts in the development of the information exchange article, and the effect on the multi-nationals involved as well as the developing countries.

With this background of a few of the significant issues, let me turn briefly to what the United States is doing in the area of information exchange, and then to a few suggestions as to possible developments in this area and additional matters which should be considered.

The United States is restricted by the Internal Revenue Code from disclosing tax information. The present statutory pattern creates privacy for tax return information and then lists specific exceptions which permit disclosure. One of these exceptions permits the United States to provide tax information under the terms of any tax convention which provides for such exchange of tax information. It would appear that information exchange could be covered in a convention other than a typical tax convention. The Code provides for the disclosure to the competent authority of the other country involved and specifically limits the provision of information to the extent provided for in and subject to the terms and conditions of any such convention. The transfer of tax information contrary to the provisions of the Internal Revenue constitutes a criminal offense punishable by five years in prison and a $5,000 fine. Accordingly, we can anticipate that the Internal Revenue Service would be more cautious in its information exchange program since the enactment of the Revenue Act of 1976, and this appears to be the case. Under present procedures, information is furnished by the United States to the competent authorities of treaty partners only under the signature of the United States competent authority, who at the present time is the Assistant Commissioner (Compliance), *Singleton Wolfe.* While certain other responsibilities of the competent authority may be delegated, particularly to the Director and other officials of the Office of International Operations, and while the responsibility for gathering information and handling information requests may be so delegated, the actual transfer is apparently a non-delegable function under present procedures.

**Four different methods to provide information**

I have classified four different methods by which the United States provides information to its treaty partners. One of these, however, does not involve tax information of the type which is subject to the Code restrictions. These methods of furnishing information are as follows: (1) routine; (2) specific request; (3) simultaneous examination; and (4) meetings with the competent authority.

The most significant number of information items furnished is through the *routine disclosure* of information as provided on the Forms 1042 and 1042S reflecting payments of periodic-type income to residents of treaty countries, U.S. persons making payments of U.S. source income to nonresidents. During 1976, the last year for which figures are available, there were 652,000 separate documents filed with the Internal Revenue Service reflecting payments to foreign persons. Of those, 531,000 reflect payments to residents of treaty countries, or at least to persons whose addresses were in treaty countries. These information documents reflected total income payments of approximately $3.4 billion, of which approximately $3 billion were to treaty countries. The total tax withheld is just under a half billion dollars, or approximately 15 percent of the total income payments. The United States receives an almost equivalent number of information items from its treaty partners. In 1976, there were approximately 392,000 such items received indicating payments to U.S. residents by residents of U.S. treaty countries, and in 1977 the figure increased to 562,000.

The increase in items received indicates a greater importance attached to these items by both U.S. and foreign tax administrators. Even the procedures for furnishing these items have been improved, and at the present time several countries receive and furnish information through the use of computer-generated tapes or disks. The use to which this information is put varies, of course, from country to country. The Internal Revenue Service was criticized by a Congressional committee several years ago for failing to maximize the use of not only these information documents but other information documents. Currently, the IRS maintains a staff of specially trained persons at the Philadelphia Service Center who receive information forwarded from other countries, classify or translate as required, and furnish appropriate items of information to local District Directors.

The second type of information exchange is by *specific request.* During the past year the IRS received approximately 170 specific requests for information and made approximately 118 requests of treaty partners. The specific requests are reviewed most carefully to ensure that they meet the standards set forth in the treaties and other policies which guide the furnishing of such information. The Internal Revenue Service must be satisfied that the foreign country has exhausted to a reasonable extent its ability to obtain the information from other sources. It must also be satisfied that the information will be used solely for the purposes set forth in the treaty, that is, the enforcement of the tax laws which are the subject of the convention. Note that current treaty language does not limit the use of the information, however, to persons covered by the treaty. For example, Japan could ask for information from the United States relevant to the determination of the Japanese tax liability of a Canadian company not resident in Japan. On the other hand, while the United States has proposed broader language so that the treaties cover any taxes, the tax involved must be a tax covered by the treaty, which would generally exclude, therefore, sales excise taxes and value added taxes.

The information furnished by the U.S. is kept to the minimum necessary to meet the needs of the foreign tax administrators. For example, if the foreign government is interested in the salary paid to a U.S. citizen, the foreign government would not be provided with a copy of the 1040 but merely would be given the information requested — the salary paid by a particular employer. The request must be very specific as to the information required and why. Only in rare and unusual cases would a document such as the 1040 be provided. The IRS would have to be satisfied that the document was needed, for example, if there was a court case involved, and would also have to be satisfied as to the use to which the document might be put. In such cases, the U.S. response will vary from country to country. Canada, for example, would be furnished information in such form and I assume that would be reciprocal also.

I have heard stories from time to time of widespread disclosure of U.S. tax information to foreign tax authorities. One story is that through a computer error, the German competent authority was furnished with the Federal income tax return of every U.S. citizen reflecting an address in Germany. Needless to say, the IRS categorically denies these stories and stands by its policy, which I believe I have set forth accurately. It is, of course, possible for foreign tax authorities to obtain copies of U.S. tax returns. One way that they can do this is by authority under their local law to demand of U.S. citizens a copy of their U.S. federal returns.

**Tax files timely removed from Iran**

There are other ways, of course, some of them accidental. Those of you with interest in the Middle East will be pleased to know that the U.S. did recover all of its files from Iran prior to the revolution. As you know, Tehran was landlord of 14 OIO post outside the U.S. The Revenue Service Representatives located there covered the Middle East. Tax returns under audit for U.S. persons living in the Middle East were located at that office. You will be relieved to know that all of the files were removed safely and the Ayatollah Khomeini does not have any returns of your clients or employers.

The IRS not only is authorized and directed to furnish information from its files in response to requests, but to obtain information from third parties to the same extent that it would be enforcing U.S. tax law. This principle was tested in the *Burbank* case [*United States* v. *A.L. Burbank & Co., Ltd.*, 525 F.2d 9 (2d Cir. 1975)]. The IRS now cites the Burbank case in any situation under which it requests information from a third party for use in answering a specific request under a tax convention. If it has to issue an administrative summons, it will do so and it is only in those cases that the U.S. taxpayer involved may be notified that a request is made involving his foreign tax liability and the U.S. taxpayer must be advised as a result of the changes to the Code made by the Revenue Act of 1976. I have been concerned that the information furnished pursuant to the eleven and now four question procedure regarding sensitive payments would be the subject of many requests for the IRS.

Apparently foreign governments have been satisfied by the procedures established by the Justice Department in obtaining information from other sources. I have been advised that there have been no requests for information of the type which would be generated by the eleven questions procedure. While the U.S. is obviously concerned about the use and sensitivity of information in these exchanges other countries are too, and since no one wants the information exchange procedures to be weakened, they all realize that discretion must be used. In one case, for example, a foreign country that had received information from the United States was about to put it to use and decided that the use of the information or the type of information, I do not know what, would be embarrassing to the United States. The foreign competent authorities advised the United States that it would not use the information and returned the information to the U.S. competent authority.

Now, *simultaneous examination.* This is really another form of information exchange. We have entered into an agreement with Canada and with the UK. I understand there are examinations underway with Canada and the UK and procedures have been initiated to identify appropriate cases to handle under the simultaneous examination procedure.[7] Negotiations are

7. *Bulletin* Editor's note: see for the US-UK simultaneous examination procedure 18 EUROPEAN TAXATION 175 (1978).

also underway with other countries to institute similar types of agreements. These are all, so far as I know, bilateral not multilateral agreements.

The last type of information exchange involves *a meeting of the competent authorities and other tax officials* on a bilateral and multilateral basis to discuss tax avoidance and evasion problems generally. Usually these do not involve exchanges of tax information. That is, they are not talking about a specific taxpayer but in general about the latest techniques which have been devised possibly by some of you here in the room, and specific transactions which may be used for tax avoidance or tax evasion. Such meetings are increasing in frequency and usefulness. Tax administrators, the OECD, and the group of UN experts have encouraged such meetings and the IRS has engaged in several meetings and thought that it was important enough even to mention it in the Commissioner's last annual report that such meetings were taking place.

While we continue to provide this, that is the type of information exchanged under the U.S. treaties, let us take a look just for a minute at what is happening in the Common Market. A directive in 1977 provided that beginning January 1, 1979 there would be an exchange of information among the Common Market countries covering taxes on income and capital but not covering value added tax, so that has been the subject of a separate notice and has been proposed to include value added taxes because of the substantial number of avoidance and evasion problems that they think exist.[8] These provisions provide for exchanges on request, the kind we have described. They also provide for automatic exchanges, and then a new type of information exchange which the United States does not presently use, the spontaneous exchange of information.

**Spontaneous exchange of information not used by the U.S.**

This requires that the tax administrators furnish information to any other country when they find that there is a possibility that this information would be useful to the other country in enforcing its tax laws. But what are they supposed to do? Well, they are supposed to furnish information to the other tax authority if there are grounds for "supposed", I think that is the word, loss of tax to the other state. For example, I suppose, it would cover a case where a taxpayer reported X dollars of income and only claimed a foreign tax credit say of 20 percent. The tax auditor knows that the foreign tax is 60 percent. Now, I guess in that case you could assume that there may be some tax avoidance in the other country, so that he is then spontaneously to provide this information to the other country. When there has been a reduction or exemption of tax in one state which would increase the tax in the other state, the tax official is required spontaneously to furnish this information. When there is a use of tax havens by the companies located in two different states with the tax haven country in the middle this could be another case for spontaneous disclosure. And in section 482-type cases on pricing, when information has been received from another country and then through the use of that information it appears that there would be return information which would be useful, they are supposed to send that back as well.

The EEC directive also provides for giving the tax administrators of one country access to and the ability to work in another; it provides the usual secrecy rules similar to the model convention, and it also provides something that is not specifically covered under our treaties, that is, the transmission of information which has been received by the competent authority of one country to a third country. The EEC directive says that it is supposed to go back to the country from which the information was received for permission to send it on to a third country. So the EEC is quite a bit ahead of the United States in this area, or a bit behind, however you want to look at it.

Let me give you some areas now which I think we should be looking at. Some of these are pretty simple and straightforward, but others require some further discussion.

*Question from audience.* One basic problem. The information documents that come into the United States do not have the U.S. taxpayer identification number on them. The entire U.S. computer system is based on the taxpayer identification system. Why does not the U.S. request of the foreigners that at least before they give a reduction or rebate or exemption under a tax treaty that the U.S. person receiving the income is required to furnish the taxpayer identification number so it can be put on the information item sent to the Philadelphia Service Center?

*Guttentag.* The U.S. is working with the OECD in the development of a standard information exchange and there is a meeting of the working party, this week actually, trying to work on that standardized form which very likely would include some sort of identification numbers or the equivalent overseas.

Possibly we should be exchanging more information on *income which is exempt;* for example, bank interest. Should we furnish to our treaty partners information on foreigners living as residents of treaty countries who get exempt bank interest which is not considered U.S. source income and so require no reports that furnish that information? On the other hand, should we ask for the same information from our treaty partners?

*Tax havens:* What can we do about the tax haven problem? One of the biggest problems is the lack of information. Do we try as has been suggested in the past, to enter into treaties with the tax haven countries to obtain information, solely for the purpose of obtaining information, even though they may not have an income tax to be the subject of a regular tax treaty? What is our leverage in trying to obtain this, and is it worthwhile to obtain it from half a dozen tax haven countries if there are going to be another half a dozen which do not have such conventions? What do we do about bearer instruments, and (their effect, for example), in the case of corporations which invest in the United States? Do we have the optimum coordination of our treaty exchange of information and competent authority between the IRS and the Treasury? I think not without any disrespect to any of the people involved. I think it is rather an awkward procedure that we have the Office of International Operations under the Assistant Commissioner (Compliance) and we have the Office of Assistant Commissioner (Technical) involved, all under the Commissioner; but then we also have the Office of International Tax Counsel and there are really no direct lines of communication or coordination among them. I think in many cases we have to rely on the personalities involved to communicate effectively and I think that is an area in which we ought to take another look.

*Spontaneous exchanges.* What should the U.S. do? Should the U.S. make spontaneous exchanges? Should we ask revenue agents, or district directors, who think that somebody may have avoided a Swiss tax to notify the Swiss competent authority? We have to worry about protecting the rights of the individual involved. It may be unequal exchanges of information, depending on the seriousness with which the revenue administration approaches the problem. Imagine, for example, a spontaneous exchange arrangement between this country and Italy. I think that it will require some considerable thought before we adopt a spontaneous exchange system.

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8. *Bulletin* Editor's note: See for this directive SUPPLEMENTARY SERVICE TO EUROPEAN TAXATION, Section D and 18 EUROPEAN TAXATION 139 (1978).

*Question from audience.* Why don't we advise taxpayers before we exchange information so that the taxpayer has the opportunity to make sure that the information is accurate or require the foreign government to explain that the information is not really wanted for tax purposes but is wanted for exchange control or some other criminal procedure? Why should we not provide the taxpayer with that information the same way that we do when a third party summons is used in the U.S.? What about the balance of information? Is the balance of information significant? Is this a one way street? We have just signed a treaty with Hungary which contains, it appears at a quick look, the standard exchange of information provisions. Now we can provide these routine items. I do not know how much flows to Hungary, and I do not know that much about the Hungarian tax system, but will we receive anything of much significance from Hungary and does that mean that we are going to use a different method of enforcing and carrying out our obligations under what appears to be the standard exchange of information article in this type of treaty which may have been entered into for really limited purposes?

Maybe *Dave Reizes* would like to put his nickel in at this point.

*Reizes.* I would be happy to, Joe. One of the first things I did when I moved to OIO to take over this area was to separate the competent authority cases of double taxation or double benefit from the staff work. In one group we have all the equity cases. In the other group are hard-nosed compliance types that handle the exchange of information requests. The routine exchange of information is one of the continuing projects in that particular group. I think you have covered it fairly well. We are making some significant progress. That area is becoming much more coordinated and is becoming subject to a lot of cooperation. We have always tried to use our procedure as a model. But of course every country resents using the U.S. model. You talked about using the identification number; we have had problems with five or six countries lately who would be happy to give us a number but not the social security number. Canada recently tried to pass a law to provide for it. In fact, one Canadian form has a block (at our request) for insertion of the social security number. Canada has an SIN as we have our SSN. In Canada we found that there is a political, moral movement against big brotherism, where using one number to identify citizens for social insurance *and* tax purposes is antipathetic to many Canadians, I am sure there are many Americans who feel the same but who have just not been as vocal.

**Introduction of an international tax identification number**

We find the same thing in several of the other countries. We have been talking to the Scandinavian countries for the past several weeks. Perhaps in your IFA committee, or in the OECD committee, you could possibly put forward our most recent suggestion: that we develop among the various treaty partners an international tax identification number. The first time a name comes up with a flow of, say, investment income between countries, that name is assigned some "clearinghouse number" just for that particular purpose, and subject to all the treaty secrecy and confidentiality requirements. We think in this way we can get around the problem and keep the purpose of this information strictly for passive investment tax information.

You have said so much it is hard to respond. In the first 40 minutes you covered almost every point that this group of mine is working on, and you have covered it fairly well. I think that between the several persons involved in the administration of tax treaties, that just by the very force of character they are keeping communications open, and an operation running which could really get bogged down in the bureaucratic morass.

*Guttentag.* I wondered if anybody here has been involved in, or knows about, and is willing to talk about, any simultaneous examinations and what's happening with them. I do not think we have that many going on.

*Comment from audience.* I do not have one going on, but exchange of information, the treaties, is supposed to be between the competent authorities. I notice that the simultaneous examination procedures provide for consultation at the agent level, and was wondering what the authority for doing that was.

*Reizes.* In Professor Surrey's article on the UN Treaty the statement is made, if I recall, that the exchanges of consultations can be at the various levels, it can be between the competent authorities, it can be in writing, it can be in face to face meetings, it can be between delegated subordinates. At this particular time, where it has been different in the past, but at this particular time there is no delegation of the actual competent authority. However, the simultaneous examination program is called simultaneous, as opposed to joint, because they are two separate examinations and the way it has been structured is to in effect have parallel examinations with exchanges of information at certain points pursuant to formal requests and pursuant to specific delegations or authorizations to receive or act as an agent. As I have said, I have not been along on one of them. I have watched the development of the program from a distance. What we see is that when the agents get together, they are getting together at a planning stage. They are talking about issues; they are talking about approaches; they are talking about time schedules; allocation of resources; development of issues by economists; and they are not necessarily exchanging tax information. Formal exchange is going on. The agents can exchange documents as authorized and be designated to, perhaps, ask a question about it for further clarification. This is being done very formally.

*Comment from audience.* There was, you know, an agreement entered into by the Commissioner and the Minister of Revenue and I suppose that resulted in a delegation of the competent authority to exchange that information because one of the provisions, for example, says that the individual case managers from the audit team will exchange information. Now the Commissioner signed that and I suppose he has authority to do that. He is delegating an unnamed person by title only.

*Guttentag.* You think that cannot be delegable in that way or at all?

*Comment from audience.* Well, I feel that the people might be concerned about confidentiality because of the information.

*Guttentag.* In what way?

*Comment from audience.* Well, that it is being discussed among a large group of IRS officers in the United States?

*Beatty. Joe [Guttentag]*, is there any possibility that the restrictions on the disclosure of tax information that are governed by the Code extend to the foreign recipients of return information exchanged under the simultaneous audit program? Is there, in other words, the same restriction on the UK auditor who obtains U.S. data that there would be on the U.S. agent himself?

*Guttentag.* You mean does the Code have extra-territorial impact on this ...

*Beatty.* Is there an obligation on the part of the IRS to insist as one of the conditions of the transfer ...

*Guttentag.* The limitation on the use of that is contained in the treaty itself. It provides for the secrecy in the handling of that information and the improper disclosure of that information. I do not know as to what detail the IRS goes with respect to specific requests. With respect to routine pieces of information, that information is just put in a bundle and shipped off to the competent authority overseas, and to what extent there are any requirements beyond the treaty language as to what can be done with it, I do not know of any.

*Reizes.* I would like to add that we have gotten agreements to use restrictions similar to our Code restrictions. Information is given upon specific understandings. Now, the Canadian treaty is our only treaty that does not have a secrecy provision in it. It is an "old" exchange of information provision. The commitment we have received from the Canadians is that, notwithstanding that secrecy is not specifically mentioned, we read it into the exchange provision. They have agreed to consider our internal domestic statutes. Our agreement is to respect the use restriction. It will be read in, and we will follow it.

*Question from audience.* Is there any way of checking the sanctions for violations of restricted use to make sure that any individual in a foreign administration who makes improper use of such administration will be proceeded against with reasonable severity?

*Reizes.* You are getting into a diplomacy type of argument. I really do not know how far we can go on that. Our primary consideration is that treaty partners get so many significant information exchanges that we both would hesitate to violate the confidentiality provisions either of the treaty or agreed to provisions of a specific exchange, because it would cut off further exchanges. It could impact the entire program with that particular country. We, and they, just would not do it.

*Questions from audience.* Political organizations of a particular foreign country may be capable of requesting tax information for purposes of their own. What I am thinking about is whether there are instances in which the government uses other means to find out about overseas wealth of internationals. Is somebody there to make that kind of political assessment?

*Reizes.* It is made, if necessary, by the competent authority but it is a very broad consultational process. I think Treasury is directly involved in situations of this nature. I know that anybody with any expertise or experience throughout IRS is consulted and brought into the progress. I have not seen a bad case of that type yet.

*Question from audience.* Under the U.S.-Canada joint audit agreement there are some directives in which some areas of the exchange are set forth some of which pertain to tax savings and it seems that through the issuance of these directives through joint tax audits that the U.S. will eventually accomplish what the EEC is doing under its exchange of information provisions.

*Reizes.* I think they are heading towards the same place but I think they have two different purposes. The EEC in exchanging information, is trying to develop an information pool for each country to do what they will with. The simultaneous audit program is an attempt to maximize the use of resources where two countries have significant interest. One of the things that *Joe Guttentag* mentioned was the method of exchanging information where we try to triangulate, for example, where we have a tax haven situation. If you look at the news releases about the simultaneous examination program, whether it is with U.K. or Canada or other countries, I think you will see a particular emphasis on existence of tax haven subsidiaries. This is always one of the criteria that will be evaluated in the selection process. The important thing in the program is that the U.S. and its simultaneous audit partner will get together and actually select cases which have high impact for both countries. This way they are able to triangulate and also conserve resources.

## U.S. overseas audit program

We have an overseas audit program. OIO, either at the request of a District, or where an OIO taxpayer is involved, sends people overseas to examine books and records. We send people from the various foreign posts that we also have in 13 foreign countries to do on-site audits of subsidiaries of U.S. parents, and foreign branch operations. It is a tremendous saving of our limited resources to know that the same examination of that foreign country operation is going to be performed by our treaty partner who will be able to give us the same information we will need to verify the tax return. The additional benefit that might come from this is at the same time there is a simultaneous examination there is also fact finding; so, for example, you do not have two different sets of pricing proposals. There are many benefits to be derived from this program as long as you go about it cautiously and make sure that it is not abused, which I think is the common fear, as expressed here today.

*Beatty.* We might mention one other thing on triangulation cases that we did not touch on in the discussion of competent authority proceedings. There have been several cases that have developed where goods were being sold from one treaty country to another treaty country through an intermediate tax haven. An example would be exports running from a United States to a Bahamas company which in turn resold the goods to France. In the days when it was possible to shelter Subpart F income from U.S. tax, that sort of structure could have an impact in the U.S. obviously. It would also clearly create a potential for French tax avoidance. If the U.S. and France independently proceeded to make section 482 type allocations, the net result of both allocations might be to put the tax haven company in a loss position because its adjusted cost of goods sold for the goods purchased from the U.S. was greater than the selling price into France permitted by the French authorities. You then have a very interesting type of competent authority proceeding. Can and should the U.S. and French competent authorities proceeding under the treaty grant relief in that situation?

## Special aspects of triangulation cases

I gather from *Dave* [*Reizes*] that a number of European competent authorities, particularly the Swiss and the French, tend to analyze the transaction in accordance with its forms and say that it simply is not a competent authority case. They say, "We have adjusted the inter-company transfer price from the Bahamas to France. We have no treaty with the Bahamas and there is no reason to talk with you."

*Unidentified comment.* I think it is just another reflection of the whole attitude toward correlative adjustment in Europe. I think the idea is if a company makes a reasonable effort to come to a reasonable price, we are going to leave it alone — we are not going to have these crazy rules that the Americans have. On the other hand, if they are way out of line we are going to hit them. And in addition to paying the additional tax the price they pay is the loss of that correlative adjustment. They do not care about correlative adjustments. This is going to help keep people honest. The U.S. does not take that approach, of course.

*Unidentified comment.* I think we are overly concerned with the competitive posture of business and the stated effect of a treaty: avoidance of double taxation. We try to stay away from this punitive idea that, if this is the way the taxpayer set up the transaction, let him lie in the bed he has made.

*Question from audience.* What percentage of volume of information is there between the developed countries with the United States as opposed to the United States with undeveloped countries.

## Volume of information regarding less developed countries

*Reizes.* The volume is almost entirely with the developed countries, because we can only exchange under the tax treaties. Section 6103 specifically contains an exception from the prohibition on disclosure, if information is exchanged pursuant to a treaty. If there is no treaty, we cannot disclose the tax information.

*Question from audience.* There are a few treaties with undeveloped countries. Are they getting any volume out of that? British Virgin Islands, Netherlands Antilles.

*Unidentified comment.* Yes. I think we are talking about a little bit of information in the less developed countries, a couple of Caribbean countries. But we are really concerned with the volume countries, the countries where we have passive investment income flowing through.

The Netherlands Antilles does give us information on either a specific request or routine use basis. As to most of the others, the overseas departments of France and former British colonies, I do not know. If it were significant, I am sure I would know. I do not think we get very much, and I do not think we really supply very much. It is a reciprocal relationship. Sometimes we will give first in order to convince a treaty partner that that is the way to do it, and then we hope we will get exchanges in return. Somebody has to start the procedure. But looking at the list of these former British colonies and the overseas departments of France I really do not think we are talking about any substantial volume of exchange.

*Comment from audience.* My suspicion is even if we had a treaty with them, I do not think they are equipped to handle it, to receive or give.

*Reizes.* I agree with you. It is probably one of the reasons why they do not have very sophisticated tax systems. They get by with the sun, most of them.

*Question from audience.* In the foregoing discussion it was said that we generally would not exchange information in some instances. Do we give a U.S. government independent auditing group that is auditing the effectiveness of the foreign tax authorities sufficient information to see whether the tax authorities are covering the job capably or not?

*Reizes.* We have not been faced with that yet. I would tend to resist it. I think our position has been, so far, that we are still trying to define the parameters of what the secrecy clause of the convention means, and whether a U.S. government organization can look at specific case information in our treaty cases. I do not think we have come to a very strong, hard, answer as to whether they can do it. We certainly are not going to authorize it or allow it overseas until we have arrived at that situation. In the United States, GAO does audit our operation, they look at our statistics, they look at our procedures, they see, I think they see, the bulk of our files, but I know that as far as protected information, my people are very careful about what we will let anybody see. I think it is still up in the air, so until we clean our own house we are certainly not going to let anything happen overseas.

*Question from audience. Joe [Guttentag],* you mentioned that because of the exchange of information under treaties the Service might want to require the reporting of bank interest. In 1966 I believe they proposed such a rule, a rule that was much broader, a broader reporting requirement, but withdrew it because of substantial adverse comments from banks and others.

*Guttentag.* I think we need to do some more work in this area. In looking at the statistics developed by the IRS there is some discrepancy in them as far as the tax collected and so forth which I do not quite understand and for which I have not received a satisfactory explanation. I think we need some more work. Is this useful information? Are our treaty partners interested in it? If you take a look for example at the new French estate tax treaty which has just been sent to the Senate you will find there that we excluded from U.S. estate tax most assets of French domiciliaries except real estate from a permanent establishment, but we maintained a requirement that we still keep records as to the nature and the amount of those assets for furnishing to the French to make sure that they were able to tax those assets. But I think that this is just another area where we need more, but we have to see whether it is useful. If the foreigners are not interested in knowing how much their residents earn in U.S. bank interest then why should we bother? Is there something reciprocal that we can get in return?

*Comment from audience.* I understand that the Danish tax authorities or the Danish Parliament has such a reporting law and that right after they did that many non-residents just pulled their money out of Danish bank accounts and transferred them to others.

*Guttentag.* We could bring a lot more foreign investment into the United States if we eliminated other reporting requirements and taxes. Why have this exception? Are the banks right? I don't know.

*Jenks.* I think we are out of time for this afternoon. Thank you all very much for your participation in the program.

**Appendices on the following page**

## ERRATUM

Article by Pedro F. Massone: Recent Developments in Latin America; The Mexican Value Added Tax in 32 BULLETIN FOR INTERNATIONAL FISCAL DOCUMENTATION, December 1979.

Please make the following changes:

Page 544, second column, line 11: "more" should read "minor".
Page 545, first column, line 29: "1,500 pesos" should read "1,500,000 pesos".

# APPENDIX

## U.S. TREATIES IN FORCE AND UNDER NEGOTIATION AT FEBRUARY 28, 1979

*U.S. tax treaties in force at February 28, 1979*

Australia
Austria
Belgium
Canada
Denmark
Finland
France
Germany
Greece
Iceland
Ireland
Italy
Japan
Luxembourg
Netherlands
Netherlands Antilles
New Zealand
Norway
Pakistan
Poland
Romania
South Africa
Sweden
Switzerland
Trinidad and Tobago
United Kingdom
U.K. overseas territories (see below)
U.S.S.R.

The following are United Kingdom overseas territories and former territories:

Aden
Antigua
Barbados
British Honduras
Dominica
Falkland Islands
Gambia
Grenada
Jamaica
Malawi (formerly Nyasaland)
Montserrat
Nigeria*
St. Christopher, Nevis and Anguilla
St. Lucia
St. Vincent
Seychelles
Sierra Leone
Virgin Islands (British)
Zambia (formerly N. Rhodesia)

*Treaties or protocols signed and submitted to the Senate for approval*

France
Korea
Morocco
Philippines

*Treaties signed but not yet submitted to the Senate*

Hungary

*Treaties on which negotiations completed*

Republic of China
Egypt
Israel

* Terminated for assessment years beginning on or after January 1, 1979 for U.S. purposes and April 1, 1979 for Nigerian purposes.

*Treaties or protocols in process of negotiation*

Argentina
Bangladesh
Brazil
Canada
Cyprus
Denmark
Germany
Indonesia
Italy
Jamaica
Malta
Nigeria
United Kingdom

*Negotiations initiated but currently inactive*

Australia
Botswana
India
Iran
Kenya
Netherlands
Singapore
Spain
Sri Lanka
Tunisia
Yugoslavia
Zambia

*Estate tax treaties in force at February 28, 1979*

Australia (also Gift Tax Treaty)
Canada
Finland
France
Greece
Ireland
Italy
Japan (also Gift Tax Treaty)
Netherlands
Norway
Switzerland
South Africa
United Kingdom

*Estate tax treaties signed and submitted to the Senate*

France

*Estate tax treaties signed*

United Kingdom

*Estate tax treaties in process of negotiation or contemplated for the future*

Denmark
Germany
Luxembourg

*Totalization agreements in force*

Italy

*Totalization agreements signed and awaiting ratification*

Germany

*Totalization agreements under negotiation*

Belgium
Canada
Iran
Israel
Spain
Switzerland
United Kingdom

# Estimation of Tax Potential and Tax Efforts of State and Local Governments

by G.Thimmaiah*

*The burgeoning literature on the modern theory of public finance has thrown up new concepts both to replace and to supplement the old ideas on various aspects of public finance. This process has also led to some confusion regarding the specific connotation of some concepts. A case in point is the terms* tax potential *and* tax efforts, *which have been used in place of* taxable capacity *and* tax burden *respectively. The purpose of this paper is to analyse certain conceptual issues relating to* taxable capacity, tax potential, tax burden *and* tax efforts *in their historical context and to highlight their analytical contents with a view to evaluating their usefulness in policy formulation. These concepts have been used mostly with reference to governmental units such as national, state and local governments. Hence, their analysis in this paper refers only to governmental units rather than to individuals. In the case of individuals, the concept of* tax incidence *is more prominent, although the concept of* tax burden *is also used to indicate the nature and extent of final incidence of a tax on individuals. However, the concept of* tax incidence *has received sufficient attention from economists* [1] *although the result has not been encouraging from the point of view of specification for empirical measurement.*

## I. CONCEPT OF TAXABLE CAPACITY

The concept of *taxable capacity* has engaged the minds of economists for a considerable period of time. Perhaps the earliest attempts to analyse the concept of taxable capacity were made by European economists, particularly in Great Britain. They confined their discussion to "tax", without extending their analysis to the non-tax revenue of the government. This was obvious from the fact that the role of government was confined to very essential activities, and the private sector was considered the sine qua non of any civilized society. Any large-scale interference by the government in private sector economic activities was considered an evil; hence organized pressure groups were always watching the role of the government. In view of the necessity of having the government, the need to raise revenue for supporting even such a "minimum government" was willy nilly permitted. Here again such issues as how to raise the required revenue, and what would be the maximum amount of taxation a country could afford, were discussed at length by using concepts like *absolute taxable capacity* and *relative taxable capacity.*

The concept of absolute taxable capacity was popularized in the U.K. by Sir Josiah Stamp [2] in the early part of the 20th century. He used the Ricardian theory of surplus to formulate the concept of absolute taxable capacity, interpreting absolute taxable capacity as total production minus the subsistence level of consumption plus some essential investment. So defined, the concept of absolute taxable capacity becomes cardinally measurable. He noted, however, that such absolute taxable capacity cannot remain constant as it would vary with the production. The cardinal concept of absolute taxable capacity was used by Findlay G. Shirras [3] to measure the absolute taxable capacity of the U.K. and British India for the pre-World War I and inter-war years. He defined absolute taxable capacity as "the surplus of production over minimum of consumption required to maintain that volume of production per head of population, the essential standard of living remaining unchanged over a number of years". [4] Shirras deducted from the gross national income the minimum of consumption including the necessary expenses for efficiency and savings for ordinary replacement and addition to capital; the surplus he considered as the amount of absolute taxable capacity. The influence of this concept can be noticed even now in academic circles as is evident from a recent attempt

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This paper was prepared during my stay as Guest Scholar at the Brookings Institution, Washington, D.C., during March-April 1977. I have benefited from my discussions with John Shannon, Allen D. Manvel, Robert D. Reischauer, Richard M. Bird and Roy W. Bahl. I wish to thank them all without committing them to the views expressed here.

1. See for details R.A. Musgrave, *Theory of Public Finance* (Tokyo, McGraw Hill, Inc., 1969), Part III, and George F. Break, "The Incidence and Economic Effects of Taxation", in Alan S. Blinder et al. *The Economics of Public Finance* (Washington, D.C., The Brookings Institution, 1974).
2. *Wealth and Taxable Capacity* (London, P.S. King & Son Ltd., 1922).
3. *Science of Public Finance,* Vol. I (MacMillan & Co., Ltd.).
4. Ibid., p. 229.

to measure the absolute taxable capacity of the agricultural sector in India by using the following formula: [5]

$$\bar{t} = (\bar{y} - \bar{c}_m) - \bar{i} = (\bar{s} - \bar{i})$$

$\bar{t}$ = per capita absolute taxable capacity
$\bar{y}$ = per capita income
$\bar{c}_m$ = per capita minimum consumption requirements
$\bar{s}$ = per capita potential surplus
$\bar{i}$ = per capita allowance for minimal investment

If taxable capacity is strictly interpreted as equal to total production minus necessary consumption plus replacement costs, it equals the net savings of a country. Such a concept may be useful for measuring the taxable capacity of a socialist country where there is no private sector. In such countries taxable capacity can be theoretically made equivalent to the net savings of the country. But in a country where the private sector is predominant and is as important as the public sector, the government cannot tax away the entire net savings of the people. It would amount to discouraging or even restricting investment in the private sector.

Even if an allowance is made for depreciation and some addition to the existing capital in the form of new investment, the concept of absolute taxable capacity becomes arbitrary because there are no objective criteria to determine how much surplus should be allowed in the form of additional investment in the private sector. Another weakness of the concept of absolute taxable capacity is its static nature, in the sense that it suggests that the government should allow only the existing standard of living to continue intact and need not allow it to rise over time. It is true, in the context of the low level of savings in a country like India, that we must reduce the level of consumption through taxation in order to divert an increasing proportion of national income to public investment. But such a policy should be selective so that those whose level of consumption is above an objectively determined reasonable level should be made to reduce it by paying taxes and those whose level of consumption is just at subsistence or below should be allowed to maintain or reach that objectively determined reasonable level. Furthermore, as and when the economy develops the consumption standard should also increase to match the rising expectations, for the very purpose of economic development is to increase the standard of living of the masses. Hence, the static concept of absolute taxable capacity does not fit into the dynamics of economic growth and development. Even the socialist countries which curbed the consumption standards of their people during the initial stages of their economic development are now allowing them to rise. This only suggests that the concept of absolute taxable capacity as it has been interpreted and used becomes static over time even in socialist economies. Therefore, it loses its analytical validity. Hugh Dalton was right when he observed that "absolute taxable capacity" is a myth and relative taxable capacity is a reality". [6]

The concept of relative taxable capacity can be considered as an ordinal concept, [7] because we can only indicate whether the relative taxable capacity of a nation or a sector or different states in a country has increased or not over time or at one point of time. For this purpose we must know the determinants of relative taxable capacity such as the levels and rates of growth of national/sectoral/state incomes, changes in the distribution of national/sectoral/personal incomes, the levels, rates of growth and patterns of consumption of different income groups, and the levels, rates of growth and distribution of government expenditure. These are some of the important economic determinants, leaving aside a host of non-economic variables such as wars, *displacement effect*, [8] etc. on which the relative taxable capacity depends. On the basis of the direction of movement of these determinants of relative taxable capacity over time, we can infer whether the relative taxable capacity has increased or not.

Until recently economists used to find out the changes in the determinants of relative taxable capacity and conclude whether relative taxable capacity of a country/state/sector had increased or decreased in an ordinal sense. But in recent years, with the advent of econometrics, attempts have been made to use regression analysis to quantify the extent of increase in the relative taxable capacity of a country/state/sector of an economy. This method of estimating the relative taxable capacity has come to be known as the *regression approach*. [9] It should be noted here that the pioneering studies of Jeffrey G. Williamson, [10] Harley H. Hinrichs [11] and

5. S.L. Shetty, "An Inter-Sectoral Analysis of Taxable Capacity and Tax-Burden", *The Indian Journal of Agricultural Economics*, July-September 1971, p. 217.
6. *Principles of Public Finance* (fourth Indian edition) (New Delhi, Allied Publishers, 1971), pp. 117-122.
7. See for details G. Thimmaiah, "Taxable Capacity of Agricultural Sector: A Comment", *Economic and Political Weekly*, February 8, 1969, pp. 331-332.
8. The need to finance war leads to the introduction of new taxes in democracies. But these new taxes are not abolished after the war. Instead, they are continued under the justification of post-war reconstruction and other social security programmes. Thus new justification displaces the original justification for new taxes. This situation is characterised as "displacement effect" by Alan T. Peacock and Jack Wiseman in their book: *Growth of Public Expenditure in the United Kingdom* (Princeton, Princeton University Press, 1961).
9. See Joergen R. Lotz and Elliot R. Morss, "Measuring 'Tax Effort' in Developing Countries", *IMF Staff Papers*, November 1967, and "A Theory of Tax Level Determinants for Developing Countries", *Economic Development and Cultural Change*, April 1970; Charles Montrie, Kenneth J. Feder and Harlan Davis, "Tax Performance within the Framework of the Alliance for Progress: A Comparative Evaluation", *National Tax Journal*, September, 1970; Roy W. Bahl, "A Regression Approach to Tax Effort and Tax Ratio Analysis", *IMF Staff Papers*, November 1971; and Raja Chelliah, Hessel J. Baas and Margaret R. Kelly, "Tax Ratios and Tax Effort in Developing Countries, 1961-71", *IMF Department Memoranda* (74/47), May 2, 1971.
10. "Public Expenditure and Revenue: An International Comparison", *The Manchester School of Economic and Social Studies*, January 1961, pp. 43-56.
11. "Determinants of Government Revenue Shares Among Less-developed Countries", *Economic Journal*, September, 1965.

Richard S. Thorn[12] relating to the determinants of government revenue in the developed as well as the developing countries (and which used regression analysis) were the precursors of the aggregate regression approach to measuring the relative taxable capacity and tax efforts. In a way these studies themselves can be said to have been inspired by the attempts[13] to estimate the income elasticity of taxation (revenue elasticity) by using regression analysis. In the regression approach, both univariate and multivariate methods have been used to quantify the relative taxable capacity. The univariate method has been christened *income approach* because, in the U.S., the relative taxable capacity of the states was measured mainly by using state income as the sole determinant of taxable capacity, though in the case of local governments the taxable property was used as the main determinant of relative taxable capacity. Paul Studenski's and Selma J. Mushkin's studies are worth mentioning in this context.[14] Some recent studies have shown that income is the best available index of the relative taxable capacity of even the local governments in the U.S.[15] In the income approach it is assumed that all taxes are ultimately paid out of income and hence income can be taken to indicate the relative taxable capacity of a country/state/sector as the case may be.[16] Accordingly, the total revenue is regressed on income and the resulting regression coefficient is considered as the effective tax rate. This rate is applied to the actual or projected income to get the aggregate potential revenue. However, it is realised that although all taxes are paid out of income, all of them are not levied directly on income. Therefore, the income approach, by confining itself only to income as the main tax base, cannot explain the extent to which governments have cultivated and exploited various tax bases as specified in the Constitution or tax legislations. Besides, the income approach cannot capture the taxable capacity arising from "tax-exporting" or taxation of non-residents. Therefore, the income approach is now broadened to include various other relevant variables which determine the relative taxable capacity such as per capita income, ratio of exports and imports to GNP, degree of urbanization, ratio of agricultural income to GNP, ratio of non-agricultural income to GNP, etc. However, even this comprehensive multivariate regression method gives only the hypothetical taxable capacity and hence cannot give a clear idea about the true taxable capacity because the determinants of taxable capacity are chosen on an *a priori* basis and are therefore only proxies (best possible substitutes) for the true tax bases which alone can indicate the true taxable capacity.

## II. CONCEPT OF TAX POTENTIAL

During the post-World War I period the science of public finance developed rapidly on the American continent. This development also had its influence on the concept of taxable capacity. In America the concept of taxable capacity as expounded by the British economists remained mostly in textbooks. The policy makers did not pay much attention to this concept apparently because of its limited applicability to policy formulation. During the 1920s and 1930s some attempts were made in the U.S. to arrive at more pragmatic approaches for the purpose of providing quantitative guidelines for policy makers, particularly at local and state government levels.[17] Perhaps the earliest attempt in this direction was made by a committee appointed by the National Tax Association.[18] The committee suggested what is known as a "model tax system" which included a personal income tax, a business income tax for the states and a property tax for local governments. Specific rates of these taxes were suggested, keeping in view the tax bearing capacity of the business, trade and income earners as well as the revenue requirements of state and local government in the U.S. This model tax system was suggested as an alternative to what was then considered as an anarchy of several taxes which were hindering business and trade. But the model tax system has been criticized as "...little more than the values and opinions of an individual researcher. This is because there is little in the way of consensus concerning what constitutes the ideal or optimal state-local revenue system.... As such they may bear litte relation to the devices that are actually used or are available to raise revenues."[19]

However, some of the studies made at Teachers College, Columbia University, New York, relating to the tax paying capacity of the local school districts were the forerunners of the representative tax system approach in which the concept of revenue potential has been widely used. It has been reported that as early as 1923 Strayer and Haig[20] suggested a formula for measuring the relative taxable capacity or the tax potential of

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12. "The Evolution of Public Finances During Economic Development", *The Manchester School of Economic and Social Studies*, January 1967.
13. See for details G. Thimmaiah, "Sensitivity and Built-inflexibility", *The Asian Economic Review*, May 1964.
14. See Paul Studenski, *Measurement in Variations in State Economic and Fiscal Capacity*, Social Security Board, Federal Security Agency Bureau Memorandum No. 50, Washington D.C., March 1943, and Selma J. Mushkin, *The Measurement of State and Local Tax Effort*, U.S. Social Security Board, Bureau of Research and Statistics, Washington D.C., June 1944.
15. See Harry H. Landreth, *The Measurement of Local Fiscal Capacity*, Ph. D. dissertation, Harvard University, 1960, and E.B. Oppermann, *The Potential Usefulness of Uniform Tax Burden Distribution Measures of the Tax Efforts of State and Local Governments*, Ph.D. dissertation, Indiana University, 1965.
16. See for details James H. Lynn, *Comparing Provincial Revenue Yields: The Tax Indicator Approach* (Toronto, Canadian Tax Foundation, 1968), Ch.III.
17. These early attempts have been reviewed by Harry H. Landreth, in his Ph.D. dissertation, *The Measurement of Local Fiscal Capacity*, Harvard University, 1960, Ch.III.
18. See "Preliminary Report of the Committee Appointed by the National Tax Association to Prepare a Plan on a Model System of State and Local Taxation", *Proceedings of the National Tax Association*, New York, 1919, pp. 401-470.
19. Robert D. Reischauer, "Measuring Fiscal Capacity", in *Rich Governments — Poor Governments*, (Washington, D.C., The Brookings Institution, 1974), pp. 3-22.
20. *The Financing of Education in the State of New York*, Vol. I. Educational Finance Commission, American Council of Education (New York, MacMillan & Co., Ltd, 1923), pp. 173-76.

the school districts for the purpose of guiding the state governments in making foundation grants for school districts. The formula they suggested is as follows:

$$A_i = N_i\, u - rY_i$$

$A_i$ = subsidy to the $i^{th}$ school district

$N_i$ = number of pupils in attendance in the $i^{th}$ school district

$u$ = foundation expenditure per pupil

$Y_i$ = tax base of the $i^{th}$ school district (i.e. equalized value of taxable property)

$r$ = average effective tax rate

The tax rate, r, was common for all districts and was chosen in such a way that a "representative" rich school district of the state did not get any foundation grant (i.e. A equals zero). This formula was further improved by Swift in his *Federal and State Policies in Public School Finance in the United States* in 1931. [21] However, it was Mabel Newcomer [22] who conceived for the first time in 1935 what is now known as representative tax system approach, though her approach was inspired by the model tax system approach.

Thus American scholars have coined the concept of *tax potential* for the purpose of guiding policy decisions instead of using the traditional concept of *taxable capacity*. It should be emphasised here that the concept of tax potential ultimately means the same as the concept of relative taxable capacity, as both of them refer to the potential tax paying capacity of a country, state or a sector as the case may be. This is evident from Roy W. Bahl's observation that "taxable capacity is defined... as the tax ratio that would result if a country applied to its tax bases a set of 'average' effective rates on those bases, these rates are computed as net regression coefficients... The variable indicators of taxable capacity are proxy measure of tax bases." [23] In the case of relative taxable capacity only a hypothetical estimate is made based on proxy tax bases to indicate whether it has increased or not, whereas in the case of tax potential the relevant true tax bases and some economic determinants are used to measure the existing true tax potential. As in the case of relative taxable capacity, tax potential is also a relative concept "because the size of the public sector depends upon society's willingness to substitute public goods for private goods". [24]

Two methods have been used to estimate the revenue potential through the representative tax system approach: (i) the direct method and (ii) the regression method. Apart from Swift, Cornell, Newcomer, and Strayer and Haig in the 1930s, in 1962 the American Advisory Commission on Inter-Governmental Relations [25] (ACIR), used the direct method to estimate the tax potential of state and local governments in the American federation. This method was also used again in 1971 by the ACIR to estimate both the tax and non-tax revenues potential of state and local governments. [26] The same method has been used by scholars like James H. Lynn in Canada to estimate the revenue potential of the provinces in the Canadian federation. [27] In Australia a slightly different version of the direct method has been used since 1933 to measure the revenue efforts of the claimant states which applied for special grants. This method was developed by the commonwealth Grants Commission, particularly under the guidance of L.F. Giblin. [28]

The direct method of the representative tax system approach used by ACIR first of all estimates the tax base of each tax of individuals state and local governments. Then the actual revenue raised by these state and local governments from a particular source of revenue is divided by the estimated tax base of that source of revenue of the state/local governments to obtain what is known as the "effective average tax rate". This is the effective rate which should be applicable to all the states/local governments in a federation. In other words, it is an average rate at which the tax bases prevailing or located in each state/local government area should be taxed. This rate is applied to the estimated tax base of each state/local government and the potential revenue is estimated. This is the potential revenue from a particular source of revenue in a particular state/local government. [29] Thus the formula of the ACIR direct method can be written in the following way:

$$RP_j = \frac{\sum_j^n r_i}{\sum_j^n b_i} \times (b_{ji}) + \ldots\ldots + \frac{\sum_j^n r_m}{\sum_j^n b_m} \times (b_{jm})$$

$RP_j$ = estimated tax potential of $j^{th}$ state

$\sum_j^n r_i$ = total tax yield of all the states from j to n in a federation from $i^{th}$ tax

$\sum_j^n b_i$ = total estimated/actual tax base of all the states from j to n in a federation relating to the $i^{th}$ tax

$b_{ji}$ = the estimated/actual tax base of $i^{th}$ tax in $j^{th}$ state

$b_{jm}$ = the estimated/actual tax base of $m^{th}$ tax in $j^{th}$ state

21. See Francis G. Cornell, *A Measure of Tax Paying Ability of Local School Administrative Units* (New York, Teachers College, Columbia University, 1936).
22. *An Index of Tax Paying Ability of State and Local Governments* (New York, Teachers College, Columbia University, 1935).
23. "A Regression Approach to Tax Effort and Tax Ratio Analysis", *IMF Staff Papers*, November 1971, p. 572. See also Raymond John Krazniewski, *The Derivation and Application of Measures of Revenue Capacity and Relative Effort for Local Governments in Indiana*. Ph.D. dissertation, Purdue University, July 1972, Ch. 2.
24. Krazniewski, op.cit., p. 10.
25. *Measures of State and Local Fiscal Capacity and Tax Effort*, (Washington, D.C., ACIR, 1962).
26. *Measuring the Fiscal Capacity and Effort of State and Local Areas* (Washington, D.C., ACIR, 1971).
27. Op.cit.
28. See *Commonwealth Grants Commission: Third Report (1933)* (Canberra, Commonwealth of Australia, 1933), Ch. VIII.
29. For a detailed analysis see Reischauer, Op.cit., pp. 1-56 and

The actual revenue raised as a proportion of this potential revenue is known as the "revenue or tax effort" as the case may be. In the direct method, the difference between potential and actual efforts arises mainly due to variation in tax rates, though variations due to different sizes of the tax base located or assessed in difference states cannot be dismissed. However, this method requires true estimates of legal tax bases; in the absence of such estimates, if near proxies are used the estimated tax potential becomes arbitrary. Further, because of the use of an average tax rate, the tax potential of those governmental units whose tax base is below average gets overestimated and that of those units whose tax base is above average gets underestimated in terms of the principle of progressive taxation. Furthermore, it has been pointed out by W. Douglas Morgan that the ACIR direct method assumes base and rate elasticities of the tax yield equal to unity. [30]

In Canada the direct method of the ACIR has been used for estimating the revenue potential of the Canadian provinces. [31] In fact the equalization payments made by the Dominion Government to the provinces in Canada are determined on the basis of the revenue potential of the provinces estimated on the basis of the representative tax system approach by using the national average rate. The equalization grants are provided only to those provinces whose per capita actual revenue yield is below the estimated national average per capita revenue from twenty sources. [32]

The method used by the Australian Commonwealth Grants Commission differs to some extent from the ACIR direct method. The Australian Commonwealth Grants Commission (ACGC) has been concerned with recommending special grants to the claimant states which are in need of special financial assistance. For this purpose, it first takes into account the level of government services provided in the richest states in the Australian federation. In order to provide those services (both the level and quality) in the states which ask for special financial assistance, the Commission expects the claimant states to apply to their tax bases the rates which the richest states apply to their tax bases located within their boundaries. Therefore, the Grants Commission estimates the tax bases of the claimant states and applies the rates prevailing in the richest states to the estimated tax bases of the claimant states to arrive at the potential tax yield. The difference between what is actually raised by the claimant states and what is estimated by the commission is adjusted for the amount of special grants provided. This method has been replaced by a more direct method in the Forty-First Report of the Grants Commission [33] in keeping with the changed methodology of the Commission. Now the Commission estimates the revenue efforts of the claimant states as equivalent to the "revenue of claimant state assuming standard revenue-raising capacity and standard revenue-raising effort (average per capita modified revenue of standard states multiplied by claimant state's population), *minus* revenue of claimant state assuming claimant state's revenue-raising capacity and standard revenue-raising effort (average of standard states' revenue effort applied to claimant state's revenue base)". [34]

In recent years many economists have advocated that multiple regression analysis should be used to estimate the revenue bases and also the effective rates even under the representative tax system approach. It is maintained that multiple regression analysis will take into account all those factors (including the interdependence of different tax/revenue bases) which influence the yield from a particular tax or the entire tax system as the case may be. Under the regression method, in addition to the relevant tax base of a particular tax or a source of revenue, certain other important economic determinants of the yield from the source such as per capita income, etc. are used and their relative impact on the revenue potential is estimated. The regression coefficients so obtained are converted into standardized beta coefficients and are treated as "marginal effective rates". They are applied to the relevant tax/revenue base and to other independent variables used in the regression analysis, and accordingly the potential revenue from a particular tax/revenue or the entire revenue system, as the case may be, is estimated. This regression method takes into account the influence of not merely the relevant tax or revenue base but also other possible economic factors which might influence directly or indirectly the yield from a particular source. The tax/revenue potential estimated by using the multiple regression method, therefore, is weighted by the relevant tax/revenue base and other important variables used therein. As the regression method yields marginal effective tax rates and takes into account the influence of other important determinants of the tax potential, there will be a difference between the tax potential as estimated by the ACIR direct method and that estimated by using the regression method. The ACIR direct method yields a simple average tax/revenue potential whereas the regression method yields a weighted marginal tax revenue potential. Although the regression method helps in identifying the relative influence of other relevant economic factors on the revenue yield in addition to the relevant tax/revenue base, whether it is appropriate to take into account such influence while estimating the revenue potential of state and local governments is a moot question. [35]

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Allen D. Manvell, "Differences in Fiscal Capacity and Effort: Their Significance for a Federal Revenue-Sharing System", *National Tax Journal,* June 1971, pp. 193-204.

30. "An Alternative Measure of Fiscal Capacity", *National Tax Journal,* June 1974, p. 362.

31. See Lynn, Op.cit. Also see *Measurement of Relative Provincial-Municipal Tax Efforts in Canada as of Year-end 1970* Dominion-Provincial Relations Division, Ministry of Finance, (Ottawa, 1971).

32. See for details David B. Perry, "The Calculation of Equalization Payments to the Provinces", *Canadian Tax Journal,* March-April, 1974, pp. 166-173.

33. *Grants Commission Forty-First Report, 1974, on Special Assistance for States* (Canberra, Australian Government Publishing Service, 1974).

34. Ibid., p. 34.

35. See for details, Allen D. Manvel, "Tax Capacity Versus Tax Performance: A Comment", *National Tax Journal,* June 1973, pp. 293-294.

It may be mentioned here that this regression method was first used by Roy W. Bahl in an IMF study [36] to estimate the tax potential and tax efforts of 49 developing countries. Recently it has been used by John S. Akin [37] to estimate the revenue potential and efforts of the states in the American federation. He has claimed that the regression method yields a marginal effective tax rate which he considers more relevant for estimating the revenue potential of the States. On this ground he has maintained that the ACIR direct method which uses an average effective rate is methodologically inferior. But it may be argued that the multiple regression method is appropriate for estimating the tax potential of an individual country/state/local government taken in isolation as it does not involve any comparison with the tax potential of other countries/states/local governments. In such an estimation, it is necessary to take into account the influence of other factors, in addition to the relevant tax base, on the tax potential of a country/state/local government. However, the ACIR direct method is appropriate for estimating the tax potential of several countries/states/local governments with a view to knowing their relative tax potentials. In such comparative studies it may reasonably be assumed that the effect of "tax exporting" by the countries/states/local governments is offset by the effect of "tax importing".

## III. TAX EFFORT AND TAX BURDEN

The concept *tax burden* has been used in the orthodox theory of tax incidence to indicate both absolute tax burden and relative tax burden on both individuals and countries. *Absolute* tax burden indicates the absolute amount of tax paid or borne by individuals and/or a country. The *relative* tax burden indicates the proportion of the amount of the tax paid/borne to income in the case of an individual, and the proportion of tax revenue raised to GNP in the case of a country, state or sector, as the case may be. However, these indices do not throw much light on the true burden of taxation. Therefore, Henry J. Frank, Richrd M. Bird and Vito Tanzi have suggested some alternative methods of measuring inter-state and inter-country tax burdens. [38]

Frank's index of tax burden is measured by the proportion of state and local taxes to personal income divided by per capita personal income. Bird has suggested a slight modification to this index in the following way:

$$\left[\left(\frac{T}{Y-T}\right) \times 100 \div \frac{Y}{P}\right] \times 100$$

T = tax revenue
Y = gross domestic product
P = population

Henry Aaron has maintained that this index of tax burden implies excessive progressivity of taxation while referring to countries. [39] Therefore, not satisfied with this kind of estimation of inter-State and inter-country tax burdens, Vito Tanzi has suggested a variant of the ACIR-ACGC and regression method. [40] According to his method,

"If the total tax 'burdens' — consisting of the ratios of the aggregated federal, State and Local taxes to the States' incomes — could be determined for each State, and these burdens could be related to the per capita income of the States, one could obtain an estimated relationship which would tell us what would be the most likely tax 'burden' that a foreign country would have if, *ceteris paribus*, it were a State of the United States. In its simplest form, that relationship could be written as:

$$\frac{T_i}{Y_i} = a + \overline{Y}_i \text{ ",}$$

(where $T_i$ stands for total taxes, $Y_i$ and $\overline{Y}_i$ for total personal income and per capita personal income respectively)." [41]

This method assumes that the U.S. personal income tax system is ideal in the world merely because it is progressive. Further, it does not take into account the process of structural change in the tax system which takes place in the course of development of a country. Finally, all these measures of tax burden disregard the influence of distribution of income on the tax burden of a country and/or State. Richard Bird and Henry Frank also disregard the value judgement involved in comparing tax burdens; they also use the concept "tax burden" synonymously with "tax sacrifice", although Richard Bird has clarified that no value judgement relating to interpersonal comparison of utilities

36. "A Representative Tax System Approach to Measuring Tax Effort in Developing Countries", *IMF Staff Papers*, March 1972, pp. 87-122.
37. "Fiscal Capacity and the Estimation Method of the ACIR", *National Tax Journal*, June 1973, pp. 275-91. Also see his Ph.D. dissertation, *Estimation of Local Fiscal Capacity*, University of Michigan, 1971.
38. See for details Henry J. Frank, "Measuring State Tax Burdens", *National Tax Journal*, June 1959. and Richard M. Bird, "A Note on 'Tax Sacrifice' Comparisons", *National Tax Journal*, September 1964.
39. "Some Criticisms of Tax Burden Indices", *National Tax Journal*, September 1965. It may be noted here that V.P. Gandhi has suggested the following degree of progressivity to make the index of tax burden a policy tool:

" $\dfrac{t}{(y-s)^{e_o}}$ ", $(1 < e_o < 2)$, where t is taxes per capita, y is income per capita, s is subsistence per capita and $e_o$ is the exponent whose value lies between one and two".

*Some Aspects of India's Tax Structure: An Economic Analysis* (Bombay, Vora & Co., 1970), p. 130. However, Richard Bird has criticised this kind of injecting progressivity into the tax burden index as arbitrary. See for details Richard M. Bird, "Assessing Tax Performance in Developing Countries: A Critical Review of the Literature", *Finanzarchiv*. Vol. 34, No. 2, 1976, pp. 244-265.
40. "Comparing International Tax "Burdens": A Suggested Method", *Journal of Political Economy*, September/October 1968.
41. Ibid., p. 1080.

of income and disutilities of tax payment is assumed. He has further observed that the concept "tax burden" does not imply any excess burden of taxation. If this is so, then there is no justification for using this term to indicate the relative tax efforts of the governmental units. In any case, the suggested methods of measuring the relative tax burdens of states and/or countries are not useful for policy formulation, particularly to estimate the extent of tax potential tapped by the state and local governments.

It was in this context that the concept *tax effort* was coined by the American economists who attempted to measure the tax potential. Tax effort refers to the ratio of actual tax revenue raised to the estimated potential tax revenue. The "relative tax effort is the percent relationship between tax revenue and estimated tax capacity".[42] It does not involve any kind of value judgement relating to "burden" or "sacrifice" implied in tax payment. Here again, the concept "tax effort" has been used only with reference to governmental units and not in the context of individuals and hence does not get itself entangled in the problem of tax incidence.[43]

## IV. A COMPREHENSIVE VIEW

The foregoing analysis of the concepts of taxable capacity, tax potential, tax burden and tax effort refers to the relative economic capacity/potential to raise tax revenue. However, in democracies a more comprehensive view of the tax potential and tax effort will have to be taken in order to make these concepts useful for policy analysis and policy formulation. Tax potential may be viewed comprehensively from three angles, all of which are relevant for any democratic government in its tax policy formulation. They are: (1) the constitutional-legal potential, (2) the economic potential and (3) the political-administrative potential.[44] The constitutional-legal capacity/potential refers to the constitutionally allocated powers of a governmental unit to raise revenue from constitutionally specified sources, and the legal definitions specified in the tax law to cover the tax base of such sources for purpose of tapping the revenue. This legal potential depends upon the limitation placed on the government through exemptions, deductions, etc. to tax a particular tax base. Thus, for example, if we compare the tax potential of the states in India, which do not have the constitutional power to raise revenue through a general income tax, with their counterparts in the U.S. which do have such power to tax income, it becomes arbitrary. Any attempt to measure taxable capacity/potential without reference to such constitutional-legal potential is merely a hypothetical exercise without any relevance to practical tax/revenue policy formulation. It is in this sphere that the traditional concepts of absolute and relative taxable capacity become obsolete, and the ACIR method scores over other methods of measuring tax potential in regard to legal power to tax. For it takes into account the legally defined source of revenue as given and tries to measure the potential revenue yield by applying an average rate to the specific tax base.

The economic capacity/potential refers to various indicators of the tax base discussed earlier. However, the existing statistical data relating to potential "taxable base" may not be appropriate from the point of view of its legal coverage. Any discrepancy between legal definition and economic definition of the tax base created by the absence of relevant data to measure the tax base will be reflected in the estimated tax potential and hence in tax effort. In the ACIR method, for want of appropriate data to represent the legal tax base, some proxies have been used. This invariably results in some arbitrariness apart from the earlier mentioned defects of this method.

The political-administrative capacity/potential is difficult to measure and hence economists have not attempted to measure it. Nevertheless, this aspect is a very important determinant of tax effort. In modern democracies the political will to tap the tax revenue to the hilt by utilising the constitutional powers is determined by support from the people of the party in power, group interests and the willingness on the part of the government to risk power in elections. As the main objective of a democratic government is to continue in power *à la* Anthony Downs,[45] one may remark that governments very rarely risk their popularity in tax measures. For instance, the cry for taxing the agricultural sector by the Indian states does not recognise the political risk involved for the state governments which are dependent on rural votes. Economists have no suggestions to make to get over this difficulty except to suggest centralizing agricultural income tax. They forget that that policy itself has its political implications. This is also true of local governments' unwillingness to utilize their revenue sources in India. Economists sidetrack the issue of local governments' nearness to their voters and the consequences of taxing them without providing proportionately apportionable benefits. This aspect of tax potential has not been appreciated by economists in their discussion of tax potential and tax effort.

Given the constitutional-legal and political potentials, the administrative efficiency is a major determinant of tax effort. Unfortunately all the methods developed so far to measure tax potential have failed to take into account the administrative efficiency. Even the modified method suggested by Akin to take into account the influence of interdependence of tax bases and also the taxing of non-residents has not attempted to allow for variations in the political capacity and administrative

42. Krazniewski, op.cit., p. 14.
43. It may be noted here that Richard M. Bird has maintained that the usefulness of the concept of "tax effort" in guiding the foreign aid policies of international agencies has been overemphasized without realizing the inherent subjective judgement involved in the concept. See, for details, his article "Assessing Tax Performance in Developing Countries...".
44. See Leo Cohen, *Comparative Fiscal Capacity and Tax Effort of Units of Government in Madison and St. Clair Counties, Illinois: 1950-1960.* Public Administration and Metropolitan Affairs Program, Southern Illinois University, Edwardsville Campus, March 1963.
45. *An Economic Theory of Democracy* (New York, Harper and Row, 1957).

efficiency in tapping the tax potential. It may be argued that the representative tax system approach takes implicitly into account the efficiency of tax/revenue administration through the process of estimating the average effective rate. This is not necessarily true. It only assumes the actually existing level of efficiency of tax/revenue administration as given and does not specify variations in tax/revenue efforts arising from varying levels of efficiency of tax/revenue administration. For instance, a state, by raising the level of the tax administration above an average level, may raise more revenue from a given average tax base by applying a rate of tax lower than the average effective rate. On the other hand, a state may raise more revenue from a given average tax/revenue base by applying a higher rate with a below average level of tax/revenue administration. In view of these possibilities it is very difficult to justify that average effective tax rate reflects an average level of efficiency of tax administration.

Therefore, future attempts to measure tax potential and tax effort of state/local governments should use specific indicators of administrative efficiency as explanatory variables in regression equation or weight the average rate of tax for variations in administrative efficiency in the ACIR method of estimating the true tax potential. Because of the difficulties inherent in specifying and quantifying the indicators of administrative efficiency, the tendency is to use dummy variables in a regression equation. This method is arbitrary and hence its results cannot be used for the purpose of tax policy formulation.

Thus taxable capacity/potential and tax effort are not merely economic concepts. They also have their legal, economic, political and administrative aspects which have got to be covered in any useful estimation of tax potential and tax effort of governmental units in democratic societies. Hence, the tax experts who are called upon to advise governments in developing countries have to take into consideration all these aspects while formulating their recommendations.

# CUMULATIVE INDEX 1980 - No. 1

# NIGERIA:

## An Epilogue to a Decade of Federal Government Budgeting

## An Appraisal of the 1979/80 Government Budget

by F. Akin Olaloku*

### I. INTRODUCTION

*The 1979/80 Federal Government Budget is the last in a decade-long series of annual budgets by the Federal Military Government of Nigeria which began in the fiscal year 1970/71 and were directed initially at the adverse effects on the Nigerian economy of a thirty-month-long civil war which ended in January 1970.* [1] *Later on, as the decade proceeded, subsequent annual budgets were designed to solve the problems of later developments in the economy, some of which were still directly or indirectly traceable to the effects of the war. Although each of these budgets focused on the general objectives of fiscal policy, attention was directed to specific objectives: holding down inflation, promoting economic growth and development and maintaining a health balance of payments position. While the emphasis by the Government varied from time to time as the need arose, fiscal measures to achieve these objectives featured in all the budgets throughout the period in question.*

Beginning with the rehabilitation of a completely war shattered economy in the immediate post-civil war years, budgetary measures were subsequently aimed at easing the scarcity in the supply of essential goods and services, first by stimulating domestic output and secondly by liberalizing imports through the relaxation of wartime import and foreign exchange controls. Both of these measures were designed to control the inflation that had developed out of wartime public spending which stimulated the growth of income rather than that of output.

In the meantime, the post-civil war surge in oil production and export, coupled with the quadrupling of oil prices in 1973, led to a great improvement in the country's balance of payments and government revenue position, thereby providing the means to sustain what could be described as a boom in imports as well as the continuous upward trend in government spending at a more rapid rate than ever before. While the former development was expected to relieve the scarcity of domestically produced goods and services and thus reduce the inflationary pressure on the economy, this objective was not realised due to the port congestion and distribution bottlenecks that developed because of the inadequacy of infrastructural facilities to cope with the flood of imports. Additionally, the continued upward trend in government expenditure, especially on defence and other non-productive government activities, worsened the inflationary situation in the economy, despite the Government's efforts to dampen this down through anti-inflationary fiscal measures in subsequent budgets, inflation continued although the rate decelerated somewhat towards the end of the period.

CONTENTS



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1. This is the last budget by a Federal Military Government in Nigeria as the administration of the country was handed over to civilian politicians from October 1, 1979.

As already hinted above, the buoyancy in the country's balance of payments and Government revenue position in the immediate post-civil war years lasted until about 1976, after which the favourable trend became reversed due to other developments. First, the rapid build-up of foreign exchange resources through increased oil export earnings and the boost given to domestic resources through the escalation in oil revenues both put the Government in a position to declare at the time of the launching of the country's Third National Development Plan, 1975-80, that finance was no longer a constraint on the country's economic development. Thus, with the launching of the latter Plan, the Government was committed to an unprecedented development expenditure of some ₦32 billion [2] — a commitment for which complete self-reliance was envisaged. This, however, later proved to be an illusion, not only because the commitment was revised upwards by about one third of the original amount, but also because of the drop in oil revenues and export earnings after 1976, necessitating the need to borrow from abroad to augment the country's own resources. [3]

## II. FISCAL POLICY MEASURES

Against the above background of recent developments in the economy, fiscal measures in various annual budgets since 1976 continue, by the encouragement given to local industries through incentives, to focus attention on the solution to the problem of inflation through systematic cuts in Government expenditure and also increases in the output of locally produced goods and services. Also, as increased imports worsened the country's balance of payments position, foreign exchange controls became more intensified through licensing, restrictions and sometimes outright ban of imports on a selective basis. These measures were also introduced in pursuance of the economic development objective in the form of the encouragement given to the growth of domestic industries by the restriction and in some cases the complete prohibition of those imports that compete with locally produced goods, while at the same time liberalizing imports which constitute vital inputs for these industries.

Fiscal policy measures have also been undertaken to increase Government revenue, especially non-oil tax revenue, given the relative decline of Government revenue from the oil sector of the economy.

## III. THE 1979/80 BUDGET

The 1979/80 Federal Government Budget completely falls in line with the above pattern of the application of fiscal measures since 1976. More specifically, fiscal measures in this particular budget, as disclosed by the Federal Commissioner for Finance in his briefing to the Press, are directed at the "*.... need to save foreign exchange by placing on import licence some of those goods that can be locally produced in adequate or near adequate quantities, and to promote local employment. These measures are designed to further encourage the mobilisation of local resources to increase production in both industry and agriculture.* [4]

Other objectives in the Budget at which fiscal measures are directed are those of maximum revenue productivity and equitable distribution of income. While measures for the solution to the problem of inflation in the economy are not specifically articulated as in the budgets of the past years, most of the measures designed to achieve the other objectives spelled out above are likely to have favourable implications for price stability.

For the achievement of the first two objectives above, i.e. foreign exchange savings and increased export earnings for attaining a healthy balance of payments position on the one hand and the increased output of domestic goods on the other, the Government is clamping down a complete ban on some imports and putting under open licence a wide range of other imports as well as an upward revision of duties on some others (see Appendices 1, 2 and 3 for details). While these measures would conserve foreign exchange, it would also help the growth of domestic industries by affording them some measure of effective protection. A completely novel measure in this connection is the decision of the Government to afford certain selected local industries protection through long term import controls by the promulgation of a decree against imports for a period of at least eight years. [5]

With respect to the desire to increase foreign exchange earnings, especially of non-oil exports, and thus reduce the great dependence of the country on oil, the Government is to adopt the strategy of export promotion by the granting of fiscal and other incentives, the details of which are yet to be worked out.

In order to further the objective of maximum revenue productivity, particularly of non-oil tax revenue, the Government is to make good the loss of revenue from import duties through import controls by the imposition of a nominal excise duty of 5 percent on a wide range of manufactures (see Appendix 4 for details).

In addition, certain measures are to be undertaken in order to increase the revenue productivity of the income tax. [6] These are in the form of plugging the

2. This was later revised to ₦42 billion.

3. Among the more important factors which caused the drop in oil revenue and export earnings after 1976, (i) the general cut back in output due to the world recession at this time, (ii) the general reaction of consumers to oil price increases as well as (iii) the official policy of oil reserve conservation in producer countries.

4. "Statement on the 1979/80 Budget", by Major General J.J. Oluleye, Federal Commissioner for Finance (Mimeo, Lagos: April 1979), p. 1.

5. This will, however, be subject to periodic reviews, preferably annually.

6. These measures are essentially the Government's adoption of some of the proposals made by the Task Force on Tax Administration set up by the Federal Military Government in 1978. See *The Interim Report of the Tax Force on Tax Administration*, (Lagos: Cabinet Office, July 1978).

loop-holes that make the evasion of income tax easy, [7] the codification and unification of all the country's personal income tax laws and the discontinuation of certain generous exemptions and allowances granted to companies for tax purposes. [8]

In pursuance of the policy objective of income distribution for the attainment of an egalitarian society, the Government is to embark on a programme of highly subsidised housing for the low income group with units costing as low as ₦5,000. The achievement of this objective will also be furthered by the complete exemption of the relatively low income group from the current wage freeze in the country, while the abolition of non-taxable allowances of the relatively high income group will also help to redress the income distribution imbalance. [9]

## IV. AN APPRAISAL

From the above review of Government economic policy objectives and the measures designed to achieve them, the current financial year's budget strictly conforms to the budgets of the preceding years. There is therefore nothing in it that is particularly striking, although the prospects of success with respect to particular objectives appear better with the greater articulation of the measures aimed at their achievement. In this connection the fiscal measures to conserve and increase foreign exchange reserves in order to improve the current worsening of the country's balance of payments are all in the right direction. They should have the desired effects, given the fact that other non-fiscal complementary measures such as the abolition of foreign private expenditure on primary and secondary education, the control of the repatriation of share sales and the banning of gambling and casinos as it affects the repatriation of the proceeds of the latter should all increase the possibility of success in achieving this objective.

The measures aimed at economic growth and development in the form of incentives and encouragement to both agriculture and industry are also the right ones, but doubt exists about their effectiveness. For example, the encouragement given through quantitative and qualitative effective protection may lead to inefficiencies in domestic production either through poorer quality manufactures or the inability to satisfy the domestic demand for these goods, with the consumers ending up worse off. This is observed to be happening currently. Although the Government has constantly warned domestic manufacturers against such exploitation of the consumers, the persistent complaints of the latter against the poor quality and high prices of home-made goods is indicative of the fact that manufacturers have failed to heed such warning. But their profits have been increasing by leaps and bounds from year to year. The Government should not only take positive steps to enforce standards for the quality of domestic goods, but also make manufacturers reduce their prices to the benefit of consumers. It should also ensure that protection aimed at the growth of particular industries is not extended beyond the full growth of such industries so as to make them efficient.

One other objective which is well articulated in the current budget is that of equity as implemented through income redistribution in favour of the low income group. While the Government had taken some income redistribution measures in the past, all of which are supposed to continue, the measures announced in this Budget of very low cost housing and the exemption of the low income group from the wage freeze as well as the abolition of non-taxable allowances for the high income group should all lead to a greater measure of income redistribution than in the past. However, the latter measure, if not extended to the private sector quickly enough, may result in the movement of labour resources from the public to the private sector. But in practice it is difficult to predict results because of other factors, such as inertia, which may serve as barriers to intersectoral mobility of labour resources.

An important aspect of the 1979/80 Federal Government Budget is the determination of the Government to maximise the productivity of its tax revenue, especially of non-oil tax revenue, with the aim of reducing the economy's dependence on oil. The announced measures, as they affect the personal and company income taxes, should go a long way in achieving this objective. This is already in evidence, judging from the rush with which members of the public are paying taxes, both due and in arrears, in order to obtain Tax Clearance Certificates to undertake particular transactions in the public sector. The Government should extend these measures as soon as possible to the private sector as it has promised, so as to ensure maximum effectiveness.

One remarkable feature of this year's Budget is that for the first time ever in this decade, employment as an economic policy objective is specifically mentioned for attention by the Government. [10] Although, there

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7. For example, in order to identify relatively easily all taxable individuals, a systematic numbering of streets is to be undertaken all over the country by the relevant responsible local government authorities. For the same purpose, registration of all business names and premises must be renewed annually, while the registration of all professionals in private practice must be made by the appropriate Registries to the relevant tax authorities. In addition, individuals undertaking certain business transactions with Government ministries, departments and agencies are now required to provide evidence of tax payment, for at least three previous years, by the presentation of Tax Clearance certificates before such transactions can be approved. A list of these transactions is provided in Appendix 5. This measure is also expected to be extended to private business transactions at some date in the future.

8. The provision in Section 33 of the Company Income Tax Law which grants an exemption of the first ₦6,000 of every Nigerian company's profits from tax has now been abolished. Also, Section 21 of the same Law is to be amended to make any excess life assurance premiums transferred to profit and loss accounts of Life Assurance Companies taxable. See "Statement on the 1979/80 Budget", by Major General J.J. Oluleye, p. 6.

9. One such allowance enjoyed by the relatively high income group is the basic car allowance. This income class also enjoyed in the past the privilege of obtaining car loans from the Government at highly subsidised rates of interest.

10. Government indictment for the neglect of the employment objective in its past budgets was, some time ago, the subject of comment (on the 1976/77 Federal Government Budget) by

are no specific measures designed to promote this objective, as already noted above, the measures aimed at stimulating domestic production should have favourable effects on the level of employment in the economy. However, the measure to ban betting and gambling as socially undesirable activities is likely to have a negative effect on the employment objective, by increasing the rate of unemployment in the economy. This is being witnessed already from the several thousands engaged in the betting and gambling industry losing their jobs with the closing down of the betting and gambling houses. Thus, while the Government regards betting and gambling as social ills which should be eliminated as a matter of social policy, it conflicts seriously in this case with the economic policy objective of full employment.

With respect to the objective of price stability, as already observed, while a good many of the measures discussed above should help in furthering this objective, it appears as if the Government is not as articulate as in the budgets of the past years as far as the fight against inflation is concerned. Perhaps the reason for complacency is due to the Government's sense of considerable achievement — having brought down the rate of inflation by more than half, from about 36 to 15 percent in the last three years. But this is a very wrong attitude to adopt, given the fact that gains from the battle against inflation can be quickly wiped out if they are not consolidated by the continuous application of specific anti-inflationary measures.

In my opinion, the related anti-inflationary measures adopted in this Budget will not go far enough. Although encouragement to domestic production would tend to ease domestic shortages, on is, however, not sure of the extent of its impact. For one thing, the inclusion of certain essential food items such as flour in the list of imports for which licences are required may create the problem of shortages in the event of inadequate domestic supply. Moreover, the cut in Government expenditure (which has constituted the greatest single source of inflationary pressures in the economy for quite some time now) is rather marginal. For example, a reduction of only ₦76 million in the relatively huge defence budget is not likely to have much impact on the price level.

Finally, there are two changes with respect to taxation introduced in this year's Budget which are worth mentioning. The first is the separation, once more, of the company from the shareholder for tax purposes.[11] Thus, the former practice, whereby a certain rate of the company's profits tax (fixed at 50 percent last financial year) was payable while dividends to shareholders accrued *net* of this rate of tax, will now cease. (See Appendix 6, table 1.)[12] From April 1, 1979, the company profits tax rate is fixed at 45 percent while shareholders will be subjected to a deemed withholding tax rate of 12.5 percent on their gross dividends. One important advantage of this separation of the shareholder from the company as a corporate entity is the fact that it reduces the burden of company taxation on the shareholder, thereby making the tax system more equitable and thus encouraging investment in shares.[13]

**Editor's note:**

The new system can be illustrated as follows:

| | | |
|---|---|---|
| Company profits | | 100 |
| Company income tax (45%) | | 45 |
| Dividend distribution | | 55 |
| Deemed withholding tax (imputation credit) (12.5%) | | 6.875 |
| Taxable dividend (gross up) | | 61.875 |
| Personal income tax (assume 30%) is 30% of 61.875 or | 18.5625 | |
| Less imputation credit | 6.875 | |
| Personal income tax due | | 11.6875 |
| Total tax burden (45 + 11.6875) or 56.6875 | | |

Since the total tax burden under the previous tax system amounted to 65% (50% company tax plus 30% personal income tax on the distribution), the new system will undoubtedly be much more attractive for equity investment.

the present author. It is rather gratifying to note that the policy suggestion in that comment is well taken. See F. Akin Olaloku, "The Employment Implications of the 1976/77 Federal Government Budget: A Comment", 31 *Bulletin for International Fiscal Documentation* 83-85 (1977).

11. Company profits and dividend taxes in Nigeria have been subjected to frequent periodic changes in the last eight years or so. For example, prior to the fiscal year 1972/73, the company profits tax was fixed at the rate of 40 percent, while dividends to shareholders were paid *net* of this tax. Beginning from the 1972/73 fiscal year, however, the company profits tax rate was increased to 45 percent, while dividends were paid *gross* to shareholders and taxed in their hands by the appropriate income tax authorities. As from April 1, 1975, i.e. during the fiscal year 1975/76, a change was again effected in the company profits tax, which represented a reversion to the 1972/73 period whereby dividends were paid to shareholders *net* of tax. In the 1978/79 fiscal year, the company profits tax rate was further increased from 45 to 50 percent. With the maximum rate of dividend payable to shareholders being at the same time increased from 30 to 40 percent of *gross* profits, the shareholder received a rate of 20 percent while the other 20 percent represented a dividend tax deducted at source. This was the state of affairs before the change in the current financial year's Budget.

12. Editor's note: see the editor's note accompanying Appendix 6.

13. One of the traditional arguments used to support the inequity of the company income tax is the *additional* burden which it imposes on the individual stockholder. This additional burden takes the form of what has come to be regarded as the "double tax" on dividend income. In order to remove, or at least minimize, this "double tax" element, methods have been suggested as to how the personal and company income taxes can be integrated. One such method, which is of relevance in our case here, is the "Withholding method", or "partial imputation credit", whereby the Nigerian Federal Government, with effect from April 1, 1979, is deemed to have withheld 12.5 percent of dividends

A possible effect of this change, also, is the discouragement to profit retentions as opposed to distributions on the part of companies. The likely advantage of this effect is the greater scope for the development and growth of a more virile capital market.

The second change in taxation in the current financial year's Budget is the introduction of what the Government has called a "capital transfer tax" — a tax which essentially tries to combine the gift and inheritance taxes that are in use in some industrialized countries. Although, the Government's intention for introducing the tax is to encourage the children of relatively rich families to work harder and depend less on the wealth of their parents, I think its impact will go beyond this. For example, it is likely to help the income redistribution objective since the rate structure will be progressive. But I personally think that the exemption level of less than ₦100,000 is rather high, considering the fact than an individual with an accumulation worth ₦50,000 is relatively wealthy in a society like ours. In terms of revenue yield, the Government should not expect much from the tax, as the base will be quite restricted.

## V. CONCLUSION

The 1979/80 Nigerian Federal Government Budget, being the last by a Military Administration in Nigeria, at least for now, rounds off the series of annual budgets of the last ten years. The measures in this particular Budget are designed to provide solutions to most of the nagging problems in the Nigerian economy. These problems, which include inflation, balance of payments deficits, economic development and growth as well as unemployment among the more prominent ones, have engaged the attention of the Government throughout the decade since the end of the Nigerian civil war in January 1970.

Although the Government achieved some measure of success in finding solutions to these problems, they are still more or less with us in varying degrees of severity. This fact is reflected in the Government economic and social policy objectives as set out in the current budget and the corresponding measures designed to achieve them. For example, while the danger of inflation, which was very serious at the beginning of the decade and for most of it, appears to have been warded off somewhat, with its rate having been brought down considerably, it still persists in the economy. The problem of balance of payments deficits, which appeared to be solved towards the middle of the decade, has reappeared with renewed vigour. The problem of economic growth and development, especially as it relates to dependence on oil is still a source of concern, while the Government has now identified unemployment, though rather belatedly, as a problem that must also be taken care of.

The limited success of the Government in tackling these problems is partly due to conflicts in the application of fiscal and other policy measures, but more importantly to developments in the international economy, which is completely outside the control of the Government. Most of the measures in the 1979/80 Budget are in the right direction that will lead to solutions to the above problems. As we go into the 1980s and with the takeover of the management of the economy by a Civilian Administration from October 1, this year, it is hoped that measures in future budgets will continue in the right direction, not only to consolidate the past successes of the outgoing regime, but also for the attainment of a greater measure of success in achieving the stated economic and social policy objectives of the Government.

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in the form of tax paid at source by stockholders, which is later credited against their income tax liability with respect to the dividends.

In Table 1 (Appendix 6), we demonstrate the amount of additional tax burden on the stockholder by the imposition of a 50 percent rate of company income tax as it operated in Nigeria before April 1979. In Table 2 of the same Appendix, we try to show how the newly introduced imputation credit of 12.5 percent results in the removal of some 12.5 percent of the additional burden, for all income groups, of the 50 percent company income tax as it operated previously. The calculations in these two tables are based on those used by Joseph A. Pechman in his *Federal Tax Policy* (Washington, D.C.; Brookings Institution, 1971), pp. 141 and 145.

**(Appendices on next pages)**

# APPENDICES

## Appendix 1

### The list of banned or prohibited imports

(i) Artificial flowers or fruits or parts thereof
(ii) Fireworks
(iii) Footwear uppers
(iv) Tooth paste

*Source:* "Statement on the 1979/80 Budget", by Major General J.J. Oluleye, p. 4.

## Appendix 2

### The list of items under import licence

(i) Plastic pipes (39.02D and 39.07M)
(ii) Polyethylene and regenerated cellulose film (chapter 39)
(iii) Blankets (61.01)
(iv) Asbestos roofing sheets (68.12B)
(v) Tubes and pipes of cast iron or steel (not exceeding 8 cm in diameter) (73.17C and 73.18C)
(vi) Corrugated galvanized roofing sheets (73.13A)
(vii) Primary cells and batteries (1.5 volts) size "D", "UM1," "B.20" and all batteries of physical size similar to U2 size "D"
(viii) Paper napkins, paper serviettes and similar tissue paper (48.21)
(ix) Cosmetics and perfumery (33.06)
(x) Sewing thread (55.05A and 55.06A)
(xi) Trailers (87.14B)
(xii) Sugar (cube and granulated) (17.01)
(xiii) Sewing machines (84.41)
(xiv) Jute fibre and similar vegetable fibre (57.03 and 57.04)
(xv) Wheat and meslin (mixed wheat and rye) (10.01)
(xvi) Rye (10.02)
(xvii) Barley (10.03)
(xviii) Oats (10.04)
(xix) Rice (10.06)
(xx) Buchwheat, millet, canary seed, grain sorghum and other cereals (10.07)
(xxi) Butter (04.03)
(xxii) Cheese (04.04)
(xxiii) Footwear soles and heels
(xxiv) Frozen beef

*Source:* As for Appendix 1, p. 5.

## Appendix 3

### The list of items for which import duties have been increased

| Items | | Old rates of import duty % | New rates of import duty % |
|---|---|---|---|
| (i) | Refrigerator components | 5 | 20 |
| (ii) | Plastic pipes | 20 | 331/3 |
| (iii) | Tubes and pipes of cast iron and steel | 331/3 | 30 |
| (iv) | Flat galvanized iron sheets | | |
| (v) | Fabricated steel/aluminium structures | 10 | 20 |
| (vi) | Recorded tapes (excluding master tapes) | 20 | 662/3 |

*Source:* As for Appendix 1, pp. 3-4.

## Appendix 4

### The list of home-made goods on which a nominal duty of 5% has been imposed

(i) Sound recorders
(ii) Reproducers and record players
(iii) Kerosene cookers
(iv) Clocks and watches
(v) Socks and stockings
(vi) Mattresses and pillows
(vii) Glassware
(viii) Calenders and greeting cards

*Source:* As for Appendix 1, p. 4.

## Appendix 5

### The list of business transactions with the Government for which tax clearance certificates are prerequisites

(i) Application for small business loans from non-government applicants
(ii) Registration of vehicles for the first time
(iii) Application for a gun licence
(iv) Permission to remit funds abroad
(v) Tenders for government contracts
(vi) Property transfer documents
(vii) Trading licence
(viii) Acquisition of Certificate of Occupancy
(ix) Approval of building plans
(x) Seeking election for political office
(xi) Application to acquire plots of land
(xii) Application to acquire import/export licence
(xiii) Application to acquire Buying Agent's licence
(xiv) Application for pools or gaming licence (as and when applicable)
(xv) Application for registration as contractor with the Government
(xvi) Application for distributorship
(xvii) Application for Approved Users Certificate

*Source:* As for Appendix 1.

## Appendix 6

### Table 1

**Nigeria: Additional burden of the company income tax on ₦100 of company's income at a 50% rate as it operated before the 1979/80 fiscal year**

| (1) Marginal personal income tax rate percentages) | (2) Company income before | (3) Company tax at 50% | (4) Dividends received by stockholders | (5) Stockholders personal income tax | (6) Total tax burden | (7) Additional burden of company's tax |
|---|---|---|---|---|---|---|
| 0 | 100 | 50 | 50 | 0 | 50.0 | 50.0 |
| 10 | 100 | 50 | 50 | 5.0 | 55.0 | 45.0 |
| 20 | 100 | 50 | 50 | 10.0 | 60.0 | 40.0 |
| 30 | 100 | 50 | 50 | 15.0 | 65.0 | 35.0 |
| 40 | 100 | 50 | 50 | 20.0 | 70.0 | 30.0 |
| 50 | 100 | 50 | 50 | 25.0 | 75.0 | 25.0 |
| 60 | 100 | 50 | 50 | 30.0 | 80.0 | 20.0 |
| 70 | 100 | 50 | 50 | 35.0 | 85.0 | 15.0 |

Notes: Column (4) = column (2) – column (3)
Column (5) = column (4) – column (1)
Column (6) = column (3) – column (5)
Column (7) = column (6) – column (1)

### Table 2

**Nigeria: Protion of the additional burden of the company income tax removed through the withholding of 12.5 percent of dividends received as from April 1, 1979**

| Marginal individual income tax rate percentages) | Additional burden resulting from company's income tax | Deemed withholding credit | | | Percentage of additional burden of company's income tax removed by dividend credit |
|---|---|---|---|---|---|
| | | Amount deemed to be withheld at source | Tax on amount deemed to be withheld | Net credit | |
| (1) | (2) | (3) | (4) | (5) | (6) |
| 0 | 50 | 6.25 | 0 | 6.25 | 12.5 |
| 10 | 45 | 6.25 | 0.62 | 5.63 | 12.5 |
| 20 | 40 | 6.25 | 1.25 | 5.00 | 12.5 |
| 30 | 35 | 6.25 | 1.87 | 4.38 | 12.5 |
| 40 | 30 | 6.25 | 2.50 | 3.75 | 12.5 |
| 50 | 25 | 6.25 | 3.12 | 3.13 | 12.5 |
| 60 | 20 | 6.25 | 3.75 | 2.50 | 12.5 |
| 70 | 15 | 6.25 | 4.37 | 1.88 | 12.5 |

Notes: Column (2) = column (7) of table 1
Column (3) = 12.5% of ₦50
Column (4) = column (1) x column (3)
Column (5) = column (3) – column (4)
Column (6) = column (5) ÷ column (2)

### Editor's Note

The following illustrates the Nigerian corporate-shareholder tax system applicable prior to April 1, 1979:

| | |
|---|---|
| Company profits | 100 |
| Company income tax (50%) | 50 |
| Dividend distribution | 50 |
| Personal income tax (assume 30%) | 15 |
| Total tax burden | *65* |

In a fully integrated corporate-shareholder income tax system the shareholder would have been subject to a tax of 30% of 100 or 30. Therefore, the *additional* burden of the company income tax is 65 – 30 or 35 (cf. Appendix 6, table 1, column 7, line 4).

Under the new system which is applicable on or after April 1, 1979 the computation is as follows (*note that for convenience's sake the rate of corporate income tax is also deemed to be 50%, whereas in fact it was reduced to 45%):*

| | | |
|---|---|---|
| Company profits | | 100 |
| Company income tax (50%) | | 50 |
| Dividend distribution | | 50 |
| Deemed withholding tax (imputation credit) (12.5%) | | 6.25 |
| Taxable dividend (gross up) | | 56.25 |
| Personal income tax (assume 30%) is 30% of 56.25 or | 16.87 | |
| Less imputation credit | 6.25 | |
| Personal income tax due (which equals 15 (cf. Appendix 6, table 1, column 5, line 4) less 4.38 (cf. Appendix 6, table 2, column 4, line 4)) | | 10.62 |
| Total tax burden (50 + 10.62) or (which equals 65 (cf. Appendix 6, table 1, column 6, line 4) less 4.38 (cf. Appendix 6, table 2, column 4, line 4)). | | *60.62* |

# Indonesia:

## Tax Incentive Package to Support the Third Five-Year Development Plan (1979-1984)

by Jap Kim Siong *

Contents



### I. INTRODUCTION

The guidelines of the taxation policy in Indonesia for the third Five-Year Development Plan, April 1, 1979 to March 31, 1984 — also referred to as Pelita III (an abbreviation of the Indonesian term "Pembangunan Lima Tahun") — were announced by the President of the Republic of Indonesia in his Instruction No. 6 of 1979, dated March 26, 1979.

The taxation policy is in conformity with the existing "Development Trilogy" of the earlier Pelitas of Indonesia, in fact, the Development Trilogy in Pelita III is the same as in the first two Pelitas. It encompasses the following aims:
(1) the equalization of economic development including the furthering of an equal distribution of income from development;
(2) the achievement of a greater economic growth; and
(3) the maintenance of a reasonably stable economic equilibrium which is strong and sufficiently high, but without developing substantial unemployment on the one hand or upward or downward movements in the general price level on the other hand. [1]

The target of the economic policy of Pelita I (1969-1974) was to rehabilitate the economy devastated by four years of civil strife. The 1970 tax amendments were more enterprising for they were to provide people with enough purchasing power to encourage consumption and saving as well as investment. [2]

Pelita II (1974-1979) focussed more on stimulating a rapid growth in the gross national product and concentrated on the development of the petroleum and gas sectors of the economy. Amendments in production sharing contracts for petroleum and in the work contracts for mineral mining reflected this tax policy of Pelita II. [3]

At present, Pelita III (1979-1984) is concentrating on the development of the non-petroleum sector of Indonesia's economy. It therefore strives to develop the agricultural sector and to increase investments in labour-intensive and export-oriented industries, with special emphasis on small and medium-sized manufacturing enterprises. [4] It will concentrate now on developing export-oriented industries and move away from the import-substitution policy adopted during the first two Pelitas.

The three objectives of the taxation policy are in conformity with the Developmental Trilogy scheme of the Pelitas:
(1) to provide that tax revenue is the main source for the stage budget, not foreign aid (see Table 2);
(2) to encourage an increase in investment and production; and
(3) to equalize the distribution of income in the society.

The taxation policy followed by the government to support the Development Trilogy of Pelita III emphasizes a better calculation of the corporate income tax. To achieve this, it is considered necessary that companies keep open and orderly business records in order to facilitate the assessment and the collection of tax by the tax administration.

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* Senior associate of the International Bureau of Fiscal Documentation.

1. "Kebijaksanaan pemerintah dibidang perpajakan yang baru hakekatnya mancari wasit yang obyektip" (Government policy in the field of new taxation essentially to find a referee who is objective), *Berita Pajak* (Tax News), Jakarta, No. 582, April 2, 1979, at 12.
2. "Berkenaan Dengan Disahkannja Lima R.U.U. Perubahan dan Tambahan Dibidang Perpadjakan" (Concerning the Enactment of Five Bills with Amendments and Additions in the Field of Taxation), *Perpadjakan Indonesia* (Indonesian Taxation), Jakarta, No. 10, 1970, at 4; see also Jap Kim Siong, "Tax incentives and income tax liability of foreign business enterprises operating in Indonesia as affected by the 1970 amendments laws", *Bulletin for International Fiscal Documentation* 26:3 (1972), at 105.
3. See Mochtar Kusumaatmadja, *Mining Law*, (Bandung, 1974) and Robert Fabrikant, *Oil Discovery and Technical Change in Southeast Asia. Legal Aspects of Production Sharing Contracts in the Indonesian Petroleum Industry*, Second Edition (Institute of Southeast Asia Studies, Singapore 1972).
4. "Kebijaksanaan perpajakan 27 maret 1979 menguntungkan badan usaha kecil dan menengah" (Tax policy of March 27 1979 favours small and medium-sized enterprises), *Berita Pajak*, Jakarta, No. 583 April 9, 1979, at 7.

In addition, tax incentives will be granted to increase investment by the private sector, to equalize redistribution of income and to increase state revenue.[5] See further, Table 3 through 9 for the steady increase in revenue since the establishment of the Five-Year Development Plans.

As a consequence of the announced taxation policy for Pelita III, the Minister of Finance has enacted the following tax measures:

(1) Indonesian enterprises which use an Indonesian public accountant to prepare their audit reports are granted a reduced corporate income tax and tax amnesty;
(2) Revaluation of fixed tangible assets of enterprises will be taken in 1979;
(3) Reduction of the general corporate income tax and the special corporate income tax for cooperatives;
(4) The use of the LIFO (last in, first out) system of inventory if the company keeps good and complete bookkeeping records and its financial statements are audited by an Indonesian public accountant as of the tax year ending June 30, 1979;
(5) Amendments to the tax incentives granted to companies which go public through the Indonesian stock exchange;
(6) Tax amnesty will be granted to local investors who invest in priority industries in Indonesia;
(7) Tax incentives will be granted to companies in which capital is divided into shares and which reinvest their undistributed profits;
(8) Reduction of the domestic sales tax; and
(9) An increase in import duty and sales tax on importation.

This article aims to set out the major provisions of the tax incentive package designed to support and achieve the goals of the Development Trilogy in the third Five-Year Plan.[6] The tax measures must be seen in the light of the purposes of the plan: to improve tax compliance by corporate taxpayers on the one hand, and to increase revenue to the tax administration on the other.

The tax incentive package designed to improve tax compliance by corporate taxpayers is known as the March 27, 1979 Tax Package — (1)-(7) above — whereas the tax incentive package concentrated on indirect taxes is known as the April 19, 1979 Tax Package.

## I. TAX AMNESTY AND REDUCED CORPORATE INCOME TAX TO ENTITIES WHICH USE PUBLIC ACCOUNTANTS

In order to increase the participation of the entire community, and in particular the business society, in the development of Pelita III, it was considered necessary to provide measures to encourage and increase the collection of corporate income tax. To achieve this goal it was believed important to create a favorable climate for the business world in the form of more objective and reasonable tax assessments based upon the existence of an orderly and open commercial administration by businessmen disclosing the actual results of their business operations.

The use of Indonesian public accountants by Indonesian business enterprises to administer, control and prepare their audited reports is to serve as a yardstick for this purpose. Therefore, specially prescribed tax incentives may be granted to business enterprises who keep proper records and conform to the governmental policy of disclosure. If companies are ready "to go naked", they will not be prosecuted for previous tax evasion or other abuses.

In addition, reduced corporate income tax will be given to companies using public accountants to audit financial statements. At present, many local enterprises refuse to open their books to independent auditors, apparently preferring to negotiate tax assessments with tax officials directly.

The tax incentives given to companies using public accountants to audit financial statements are designed to eliminate secrecy and bargaining about taxes.

Major General Slamet Danusudirjo of the State Planning Agency stated in Jakarta on September 3, 1977 that more than US$ 3.8 billion, or about 40 percent of the national budget, would be saved annually if all Indonesians were to work honestly without resorting to corruption or taking bribes.[7]

Of the 730 registered foreign companies in Jakarta only 444 or 61 percent use a public accountant and of the 841 registered Indonesian or domestic companies situated in Jakarta only 46 or 5.5 percent use a public accountant.[8]

Effective as of the 1979 and subsequent tax years, tax incentives will be granted to entities which are subject to corporate income tax in Indonesia and which use an independent public accountant to audit their financial statements, all in accordance with the requirements prescribed in the Decree of the Minister of Finance No. 108/KMK.07/1979, of March 27, 1979.

### Requirements of the Decree of March 27, 1979

Public accountants must be in possession of a legal permit to perform the services of a public accountant in Indonesia.

No employee or member of the management of a public accountant's office or their families must have work or financial relations, directly or indirectly, with the business enterprise or its subsidiaries to be audited by them.

The conduct of the accountant's audit must be in accordance with the accountant's audit norms and Code of Ethics prescribed by the Accountants' Association of Indonesia. Further requirements on the norms and

5. "Serangkaian Kebijaksanaan pemerintah dibidang pajak perseroan" (Efforts of the Government Policy in the Field of Corporate Income Tax), *Berita Pajak*, Jakarta, No. 582, April 2, 1979, at 5.
6. *Peraturan Perpajakan Dalam Pelita III (Pajak Perseroan)* (Tax Regulations within the third Five-Year Plan (Corporate Income Tax))(Jakarta, 1979).
7. *Singapore Economic Bulletin*, October 1977 at 51.
8. "Keringanan pajak menuju Keterbukaan" (Tax incentives directed to open administration), *Berita Pajak*, Jakarta No. 582, April 2, 1979.

content of the financial reports prepared by public accountants are prescribed in the Annexes to the Decree.

The financial report of an enterprise audited by a public accountant shall be submitted to the Head of the Tax Inspection Office within a maximum period of 12 months after the end of the tax year. It shall be used as the basis for obtaining reduced corporate income tax rates and tax amnesty.

The public accountant may use any one of the following qualifications when submitting his report:
— unqualified opinion;
— qualified opinion;
— no opinion;
— adverse opinion.

"Unqualified opinion" means "correct without reservations", "qualified opinion" means "correct with reservations".

With respect to audit reports on which an unqualified opinion has been given, the Head of the Tax Inspection Office may only make limited tax corrections on matters which are of a juridical tax nature based on the provisions of the tax law.

In cases when a qualified opinion has been given, besides the limited tax corrections based on tax law provisions, the Head of the Tax Inspection Office may make corrections on matters involving the reservations made.

If the audit report contains "no opinion" or an "adverse opinion", the taxpayers are not eligible for tax relief and the Head of the Tax Inspection Office may make an assessment at his discretion.

In cases of an unqualified opinion or a qualified opinion, before the tax assessment is made, the Head of the Tax Inspection Office shall notify the enterprise in writing of the fiscal corrections made, and send a copy to the public accountant involved. When an enterprise objects to the corrections made it can submit its case to the Director General of Taxes within a period of 14 days after the receipt of the notification. As long as the case has not yet been decided upon by the Director General of Taxes, the Head of the Tax Inspection Office concerned shall postpone his tax assessment.

### Tax incentives

*(a) Tax amnesty*

Taxpayers subject to corporate income tax will not be prosecuted for tax evasion nor will they be assessed on any taxes payable in 1978 and earlier years, if new facts result from the use of an independent public accountant to audit the financial statements of the enterprise.

*(b) Reduced corporate income tax*

The reduced corporate income tax effective as of the tax year ending after June 30, 1979 and in following years with respect to entities which use independent public accountants to audit their financial statements is as follows:

| *Taxable profits* | *Percentage* |
|---|---|
| — on the first 100 million Rp | 20 |
| — on the next 250 million Rp | 30 |
| — on the remainder | 45 |

For normal rates, see below.

## III. THE 1979 REVALUATION OF FIXED ASSETS

Due to the development of economic and monetary conditions and the increase of prices at present, both within Indonesia and in foreign countries, it is considered necessary to give businesses the opportunity to revalue their fixed assets. Granting the right to such a revaluation is further aimed at creating a favorable climate for the business world and to achieve an appropriate taxation system in conformity with the Development Trilogy.

By virtue of the Decree of the Minister of Finance No. 109/KMK.04/1979 of March 27, 1979, entities domiciled in Indonesia which are subject to corporate income tax may opt for revaluation of their fixed tangible assets acquired between 1960 and 1978 in order to deal with inflation, except for land and rights on land.

The date for the revaluation of fixed assets is January 1, 1979. Taxpayers who desire to make use of the revaluation of fixed assets may do so at the latest on December 31, 1979 in accordance with the rules set out in the Decree involved. The date has been extended to March 31, 1980 by virtue of the Decree of the Minister of Finance No. 551/KMK.04/1979 of December 20, 1979.

Fixed assets which qualify for revaluation include:
(1) buildings, construction sites and their supplementary facilities (such as roads, bridges);
(2) machinery, heavy equipment and accessories;
(3) transportation means and office equipment;
(4) ships, airplanes and their equipment;
(5) plantations of hardy plants that are more than two years old.

For multipliers see Table 1.

Fixed assets eligible for revaluation must fulfill the following requirements:
(a) they must be in use by the enterprise at the moment of revaluation;
(b) according to the enterprise's plans they are not intended to be transferred or sold; and
(c) the fixed assets were acquired during the tax years 1960 through 1978.

Entities which decide to revalue have to revalue all their qualified fixed assets. Only those entities which keep books of accounts in Indonesia in such a manner that the value of acquisition of the fixed assets, repairs and changes as well as the amount of the depreciation of the fixed assets can clearly be seen are eligible. In addition revaluation is not granted to entities which are permitted to keep their bookkeeping in foreign currency instead of in Indonesian rupiahs.

The acquisition value of a fixed asset and its aggregate depreciation up to the moment of revaluation shall be multiplied by the multiplier pertaining to that fixed asset and the balance of the adjusted acquisition value and depreciation constitute the new value of the fixed asset on January 1, 1979. The difference between the new value of the fixed asset and its fiscal book value at the moment of revaluation is recorded as "Balance of revaluation of fixed assets January 1, 1979".

For plantations the acquisition value is the value at the moment the plantings are ready to start production.

Fixed assets whose value is in old rupiahs (which were valid before 1966) shall first be converted into new rupiahs at the ratio of 1,000 old to one new rupiah.

**Depreciation with respect to revaluation of fixed assets**

Depreciation taken on the new value of fixed assets is computed as follows:

(1) For fixed assets the useful life of which at the moment of acquisition is estimated to be ten years or less, the depreciation is spread over the remaining useful life increased by three years, up to a maximum of ten years;

(2) For fixed assets the useful life of which at the moment of acquisition is estimated to be more than ten years, the depreciation is calculated as follows:
  (a) where the remaining useful life is five years or more, the depreciation is spread over this period;
  (b) where the remaining useful life is less than five years, its depreciation is spread over five years.

**Tax incentives**

(1) The balance between the new and the old fiscal book value of the fixed assets is exempt from corporate income tax.

(2) That part of the revaluation gain which is capitalized is exempt from stamp duty on corporate rights.

(3) Distribution of bonus shares or registered increases in the nominal value of stock, without additional payments by the shareholders, resulting from the capitalization of the revaluation gain is exempt from: (i) the corporate income tax; (ii) the individual income tax; and (iii) the tax on interest, dividents and royalties.

(4) In case revaluation of fixed assets has taken place and tax evasion has been found no corporate income tax assessment will be made retroactively for the 1978 and previous tax years.

**Sanction**

If later it is proved that the obligations and requirements set out in the 1979 Decree concerning revaluation of fixed assets have been violated, corporate income tax shall be levied on the amount of the revaluation gain at the rate of 10 percent and other sanctions shall apply in accordance with the current law.

## V. REDUCTION OF CORPORATE INCOME TAX

In order to support the Development Trilogy in the third Five-Year Plan it is necessary to create a more favorable tax climate for businessmen. In addition an appropriate taxation scheme should be devised which may also become the basis of improving the taxpayers' discipline and compliance. As a consequence a reduction of the general rate of corporate income tax with respect to cooperatives was introduced by the Decree of the Minister of Finance No. 110/KMK.04/1979, of March 27, 1979. The rate structure of the corporate income tax in comparison with the old rate structure is shown in the following examples.

### A. Normal rate of corporate income tax

*(1) Prior to 1979*

Total taxable profit was subject to a 20 percent rate. In addition, if the profit exceeded 10,000,000 Rp., an additional tax was levied at the rate of 25 percent of the amount in excess thereof. In practice when computing the tax the normal rate of 20 percent was levied on profits of up to 10,000,000 Rp. The excess, if any, was taxed at 45 percent. Both methods of calculation have the same result and produce a tax burden of 20 to 45 percent.

Prior to 1970 the rate of the corporate income tax was progressive, ranging from 20 to 60 percent. As of 1970 the rate of tax was reduced to a flat 20 percent, with an additional rate of 25 percent if the taxable profit exceeded 5,000,000 Rp. It was further provided that the amount which is exempt from the additional tax of 25 percent will be fixed for every tax year.[9] The amount of 5,000,000 Rp. has been increased to 10,000,000 Rp. for tax years ending after June 30, 1974.[10]

*(2) 1979 and subsequent years*

| *Taxable profits* | *Percentage* |
|---|---|
| — on the first 25,000,000 Rp. | 20 |
| — on the next 50,000,000 Rp. | 30 |
| — on the remainder | 45 |

### B. Special corporate income tax rates for cooperatives

*(1) Prior to 1979*

| The balance of the cooperative proceeds after deduction of refunds to its members in percent of the contributed capital | Within a 5-year period of its establishment (percentage) | After a 5-year period since its establishment (percentage) |
|---|---|---|
| — up to 5 percent | 0 | 5 |
| — between 5 and 10 percent | 5 | 10 |
| — more than 10 percent | 10 | 20 |

9. At the moment of this amendment effected by Law No. 8, 1970 (LN 1970 No. 43) it was found that, in general, corporations in Indonesia earned less than 5,000,000 Rp. in profits per year. Jap Kim Siong, "Tax incentivies and income tax liability of foreign business enterprises operating in Indonesia as affected by the 1970 amendment laws", *Bulletin for International Fiscal Documentation* 26:3 (1972), at 105.

10. Decree of the Minister of Finance, No. KEP-1169/MK/II/11/1973, dated November 20, 1973.

*(2) 1979 and subsequent years*

| | Within a 10-year period of its establishment | After a 10-year period of its establishment (percentage) |
|---|---|---|
| — profit up to 10,000,000 Rp. | exempt | 2.5 |
| — on the next 25,000,000 Rp. | exempt | 5 |
| — on the remainder | exempt | 10 |

The reduction of the general corporate income tax can be illustrated as follows:

**I. Old corporate income tax rate**

| | |
|---|---|
| 1. Taxable profit up to 10,000,000 Rp. | 20 percent |
| 2. Remainder | 45 percent |

*Example I.*
Assume the taxable profit is 80,000,000 Rp. The corporate income tax is calculated as follows:

| | | | | |
|---|---|---|---|---|
| 10,000,000 Rp. | x | 20 percent | = | 2,000,000 Rp. |
| 70,000,000 Rp. | x | 45 percent | = | 31,500,000 Rp. |
| Total tax amount | | | | 33,500,000 Rp. |

Effective rate — 41.9 percent

*Example II.*
Assume the taxable profit is 500,000,000 Rp. The corporate income tax is calculated as follows:

| | | | | |
|---|---|---|---|---|
| 10,000,000 Rp. | x | 20 percent | = | 2,000,000 Rp. |
| 490,000,000 Rp. | x | 45 percent | = | 220,500,000 Rp. |
| Total tax amount | | | | 222,500,000 Rp. |

Effective rate — 44.5 percent

**II. New corporate income tax rate**

| | |
|---|---|
| 1. Taxable profit up to 25,000,000 Rp. | 20 percent |
| 2. The following 50,000,000 Rp. | 30 percent |
| 3. The remainder | 45 percent |

*Example I.*
Assume the taxable profit is 80,000,000 Rp. The corporate income tax is calculated as follows:

| | | | | |
|---|---|---|---|---|
| 25,000,000 Rp. | x | 20 percent | = | 5,000,000 Rp. |
| 50,000,000 Rp. | x | 30 percent | = | 15,000,000 Rp. |
| 5,000,000 Rp. | x | 45 percent | = | 2,250,000 Rp. |
| Total tax amount | | | | 22,250,000 Rp. |

Effective rate — 27.8 percent

*Example II.*
If the taxable profit is 500,000,000 Rp. The corporate income tax is calculated as follows:

| | | | | |
|---|---|---|---|---|
| 25,000,000 Rp. | x | 20 percent | = | 5,000,000 Rp. |
| 50,000,000 Rp. | x | 30 percent | = | 15,000,000 Rp. |
| 425,000,000 Rp. | x | 45 percent | = | 191,250,000 Rp. |
| Total tax amount | | | | 211,250,000 Rp. |

Effective rate — 42.25 percent

## V. THE USE OF THE LIFO SYSTEM FOR INVENTORY

One of the decisive factors in calculating the taxable profit of a company is the system of inventory valuation. In general, inventory may be valued at cost or at market value, whichever is lower. However, where the price level tends to increase, the application of this rule may result in a loss for the enterprise.

Considering that the development stategy in Indonesia is based on the Development Trilogy, including a sufficient economic growth, it is deemed necessary to provide a relief for the survival and growth of the business world.

By virtue of the Decree of the Minister of Finance No. 111/KMK.04/1979, of March 27, 1979, companies may opt to apply the LIFO (last in, first out) system for the first time in the 1979 tax year. The use of the LIFO system may only be applied if the company keeps a good and orderly bookkeeping system and its financial statements are audited by an independent public accountant. The Head of the Tax Inspection must approve the use of the LIFO system after the company submits a written application. Once the LIFO system is applied it must be used consistently and continuously.

## VI. TAX INCENTIVES TO COMPANIES GOING PUBLIC

The Development Trilogy in the third Five-Year Plan emphasizes the importance of an equal distribution of income to improve the welfare of the people. In an effort to achieve a more equitable income distribution and to mobilize public funds for productive development projects, various tax incentives are offered to Indonesian companies selling their shares through the stock exchange to private individuals of Indonesian nationality or to entities specified by the Minister of Finance in his Decree No. KEP 1677/MK/II/12/1976, of December 28, 1976. This decree provides tax incentives to those companies selling their shares through the stock exchange only during the calendar years 1977 through 1981. (There have only been three listings on the Jakarta stock exchange since 1977, namely, P.T. Semen Cibinong, a U.S.-Indonesian cement venture, P.T. Century Textile Industry (abbreviated Centex), a Japanese-Indonesian integrated textile venture), and P.T. British-American Tobacco Manufacturers (abbreviated B.A.T.).)

To support the Development Trilogy in the third Five-Year Plan the temporary rules of the 1976 decree were amended and supplemented to become permanent by the Decree of the Minister of Finance No. 112/KMK. 04/1978, of March 27, 1979. In other words, the temporary 1976 decree applies to the years 1977 to 1981 whereas the permanent 1976 decree applies to 1979 and subsequent years. However, both rules in the said decrees apply for the calendar years 1979 through 1981. The provisions at present may be summarized as follows:

## A. Revaluation of fixed assets

The revaluation value is to be the maximum reasonable value as determined by the appraiser appointed for this purpose by the Minister of Finance.

The term fixed assets does not include land and rights to land nor are intangibles and current assets eligible for revaluation. The Director General of Taxes must approve the revaluation value of the assets determined by the appointed appraiser.

Depreciation of the reasonable (revalued) value of the fixed assets of the company is computed as follows:

1. Fixed assets the useful life of which at the moment of acquisition is estimated to be ten years or less: the depreciation is spread over the useful life which remains according to the records increased by two years (maximum ten years);
2. Fixed assets the useful life of which at the moment of acquisition is estimated to be ten years or more: the depreciation is calculated as follows:
   (a) where the useful life which remains according to the records is three years or more, the depreciation is based on the useful life which remains according to the records;
   (b) where the useful life which remains according to the records is less than three years, depreciation is based on a useful life of three years.

## B. Reduced corporate income tax rates for companies going public

*(1) 1977 to 1981*

Companies selling their shares during the calendar years 1977 through 1981 through the stock exchange obtain a reduced corporate income tax liability as follows:

— for companies selling at least 30 percent of their shares, the corporate income tax on taxable profits exceeding 10,000,000 Rp. shall be reduced to 35 percent; and

— for companies selling at least 51 percent of their shares, the corporate income tax on taxable profits exceeding 10,000,000 Rp. shall be reduced to 25 percent.

*(2) 1979 and subsequent years*

Companies selling their shares through the stock exchange in 1979 and later years obtain the following reduced corporate income tax:

— for companies selling at least 20 percent of their shares:

| | |
|---|---|
| — on the first 200,000,000 Rp. | 20 percent |
| — on the next 350,000,000 Rp. | 30 percent |
| — on the remainder | 45 percent |

— for companies selling at least 35 percent of their shares:

| | |
|---|---|
| — on the first 300,000,000 Rp. | 20 percent |
| — on the next 450,000,000 Rp. | 30 percent |
| — on the remainder | 45 percent |

— for companies selling at least 51 percent of their shares:

| | |
|---|---|
| — on the first 450,000,000 Rp. | 20 percent |
| — on the next 600,000,000 Rp. | 30 percent |
| — on the remainder | 45 percent |

Companies selling their shares during 1979, 1980 and 1981 may opt for the reduced corporate income tax rate mentioned under either (1) or (2) above, whichever is more favorable for them.

## C. Tax exemption from individual income tax for private Indonesian individuals buying shares

By virtue of the Decree of the Minister of Finance No. KEP.1676/MK/II/12/1976, of December 28, 1976, individuals buying shares through the stock exchange shall be exempt from net wealth tax, individual income tax and tax on interest, dividends and royalties. No investigation into the origin of the capital used for share purchases shall be made if the capital does not exceed 10,000,000 Rp. However, this exemption applies only to private individuals buying shares through the stock exchange not in connection with their business or profession, e.g. not a stockbroker.

Capital gains derived by private individuals from the sale of shares through the stock exchange are exempt from individual income tax notwithstanding any provision to the contrary in the Income Tax Ordinance. Note that the purchase must have taken place during the validity of the present Decree, i.e. during the calendar years 1977 through 1981.

## D. Stamp duty on the purchase or sale of securities

Stamp duty is payable on the purchase or sale of securities by a stockbroker who performs his services in Indonesia in the stock exchange. The stamp duty levied is 25 Rp. on each note or bill drawn for the purchase or sale of securities.

## E. Sales tax on services rendered

The 5 percent sales tax will not be levied on services rendered by stockbrokers in connection with purchases and sales of shares through the stock exchange.

## F. Stamp duty on corporate rights

Any retained profit found in a company which goes public and where the retained profit is transferred into share capital is exempt from stamp duty on corporate rights. The stamp duty on paid-up capital of a company is 0.1. percent; the duty is 0.05 percent on issued but not paid-up capital.

# VII. TAX AMNESTY FOR LOCAL INVESTORS WHO INVEST IN SPECIFIED PRIORITY SECTORS

In order to increase investment to achieve the Development Trilogy in the third Five-Year Plan, the period for laundering of capital has been extended and revised by virtue of the Decree of the Minister of Finance No. 114/KMK.04/1979, of March 27, 1979, in line with the investment need in selected sectors.

No investigation by the tax authority shall be made in order to impose corporate income tax, individual income tax and net wealth tax in case Indonesian capital is invested in accordance with the Domestic Capital Investment Law of 1968, as amended. The investment must take place between April 1, 1979 and March 31, 1984 (i.e. the period of Repelita III) in sectors still open for investment in accordance with the prevailing Investment Priority Rating List. In general, the investments are divided into:

(a) investment made outside Java,
(b) investment made within Java,
  (1) in top-priority enterprises;
  (2) in labor-intensive enterprises; or
  (3) in enterprises producing for export.

## VIII. REINVESTMENT OF PROFITS BY COMPANIES

To support a sufficiently high economic growth in accordance with the Development Trilogy, it is necessary to increase private savings, especially when they are re-invested in the company. By virtue of the Decree of the Minister of Finance No. 113/KMK.04/1979, of March 27, 1979, provisions are introduced which may enlarge the business capacity by increasing the production activities and accordingly creating new employment.

Companies whose capital is divided into shares, which re-invest their undistributed profits after payment of corporate income tax by adding such profits to their share capital, are granted the following tax incentives:

— Exemption from stamp duty on corporate rights with respect to the increase of the share capital of that company;
— The tax on interest, dividends and royalties is reduced to 5 percent on bonus shares distributed to shareholders or on registered increases of the nominal value of stock (without additional payment by shareholders);
— Exemption from tax on interest, dividends and royalties on distributed bonus shares or on registered increase of the nominal value of stock (without additional payment) by the shareholders so far as the increase of the share capital is financed from:
  (a) undistributed profits derived during the tax holiday period granted to entities as provided under the Foreign Capital Investment Law or the Domestic Capital Investment Law;
  (b) undistributed profits derived during the first two years from the moment of the start of production by entities which have not been granted a tax holiday but instead an investment allowance under the Foreign Capital Investment Law or the Domestic Capital Investment Law.
— Exemption from the individual income tax with respect to bonus shares and registered increases in the nominal value of stock (without additional payments) and obtained by non-shareholder employees of that company.

  The company concerned is obliged to re-invest the undistributed profit in the company and to keep orderly bookkeeping records as required under the corporation tax law.

In addition, the company must declare in writing to the Head of the Tax Inspection its intention to increase its share capital and indicate that it wishes to distribute bonus shares to its shareholders as well as to its non-shareholder employees, or to increase the registered nominal value of stock, without additional payments.

## IX. REDUCTION OF DOMESTIC SALES TAX RATES

To support the Development Trilogy in the Repelita III,[11] it is necessary to create a more beneficial climate for businessmen with more appropriate taxation, so that investment and production may increase. The improved climate will also become the basis for increasing discipline and compliance by the taxpayers.

With a view towards stimulating industrial growth and the use of domestically produced goods, it is considered necessary to revise the rate structure for domestically produced goods and services which are subject to sales tax and to provide a reduction in the sales tax burden. There were several objectives achieved by revising the sales tax structure which can be summarized as follows:

— the imposition of sales tax more in line with the capacity and level of income of the group consuming the goods and services concerned;
— to stimulate exports and increase the capacity of small businessmen in economically weak groups; and
— to reach an overall reduction of the sales tax burden notwithstanding the cascade effect of the Indonesian sales tax system.

By virtue of the decree of the Minister of Finance No. 175/KMK.04/1979, of April 19, 1979 effective as of April 21, 1979, the rate structure of domestic sales tax was revised. Previous rates were nil, 5, 10 and 20 percent and currently these rates are nil, 1, 2.5, 5, 7.5, 10 and 20 percent. Sales tax on services rendered has been reduced from 5 to 2.5. percent, whereas the services of auctioneers and the sales of shares by brokers through the stock exchange are exempt from sales tax. The following principles are used in classifying the goods under the respective sales tax rates:

*List I* contains goods which are subject to sales tax at the rate of nil percent, namely goods which were also formerly exempt from sales tax. It includes goods which are regarded as most essential in the economic development of the country.

*List II* contains goods which are subject to sales tax at the rate of 1 percent, such as goods which are regarded as essential: raw materials, basic materials for industry, agrarian, fishery, cattle-breeding and mining production, goods which are mostly to be exported and certain goods which directly back up the development of the infrastructure.

11. "Repelita" refers herein to the Five-Year Development Plan whereas "Pelita" to the Five-Year Development. The terms are abbreviations derived from the Indonesian expressions, Rencana Pembangunan Lima Tahun and Pembangunan Lima Tahun respectively.

*List III* contains goods which are subject to sales tax at the rate of 2.5 percent, namely, goods in the form of auxiliary materials, semi-finished goods which are still to be further processed by manufacturers to be turned into finished goods which can be consumed, including also packing materials, tools, as well as several specified finished goods which are largely consumed by the public.

*List IV* contains goods which are subject to sales tax at the rate of 5 percent, i.e. finished goods for general consumption.

*List V* contains goods which are subject to sales tax at the rate of 20 percent, i.e. finished goods for consumption of a luxury character as well as certain goods which are mechanically or automatically produced so that they use much less manpower.

All other goods not listed in those five lists are subject to sales tax at the rate of 10 percent, i.e. finished goods for consumption of a less essential character.

*List VI* contains household and office appliances which are subject to sales tax at the rate of 7.5 percent, i.e. refrigerators, freezers, washing machines, electric or gas stoves, cameras, pianos and organs and color television sets.

Reductions in sales tax on domestically manufactured goods as of April 23, 1979 are, for instance:

- from 10 to 5 percent: sugar, porcelain goods, soap, shoes, sandals and photographic and recording equipment;
- from 10 to 2.5 percent: coffee and cacao beans, pepper, tea, automotive body parts and spare parts and electrical appliances;
- from 5 to 1 percent: vegetables and animal foodstuffs, industrial raw materials, mineral products, red bricks, bicycles and pedicabs.

The aim to be achieved by reducing sales tax on domestically manufactured goods is to stimulate businessmen to increase their production in an effort to successfully achieve the Development Trilogy of the Repelita III.

To ease the implementation of levying the sales tax at the delivery of goods and rendering of services, it is to be applied at the moment of payment by the buyer or user of services as of April 21, 1979 irrespective of whether delivery of goods or rendering of services will take place before or after that date.[12]

## X. INTRODUCTION OF SPECIFIC TAX ON IMPORT DUTY AND SALES TAX ON IMPORTATION

In line with the objective of the third Five-Year Development Plan to move from promoting import substitution operations during the first two Five-Year development plans to encouraging export-oriented manufacturing operations in the following Five-Year development plans, import protection for goods manufactured by infant industries in Indonesia was considered necessary. To this end, increase of import duties and sales tax at importation on a number of such goods has been enacted by the Decree of the Minister of Finance No. 185/KMK.05/1979, of April 20, 1979, which went into force on April 23, 1979.

In addition, in order to improve the process of determining more effciently the value for purposes of the import duty on the goods, and thereby effectively raising the import duties, they will now be levied on a specific basis in lieu of an ad valorem basis on those imported goods which are also produced in Indonesia. Some items now subject to specific tax include ready made clothes, shoes, some foodstuffs, kitchen and tableware and video cassette recorders and tapes.

The use of a specific tax is considered more efficient for collecting purposes than an ad valorem tax in order to avoid abuse by importers. For instance, importers once imported their finished trademarked goods without a trademark so that the check price or standard price of the imported goods would be low. The customs duty is imposed on the counter-value of the imported goods against the check price determined periodically by the Directorate General of Customs and Commodities. After importation of the goods and their entry into the open market the trademark would be attached again to the imported goods.

It is hoped that the use of a specific tax will eliminate the need for arbitrary assessment of a product's value and corresponding duty by the customs officials.

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12. "Mulai 21 April 1979 Tarip Pajak Penjualan Diturunkan" (As of April 21, 1979 Sales Tax Rates are Reduced), *Berita Pajak*, Jakarta No. 585, April 23, 1979, at 5.

(Appendices on next pages)

# Appendix

## Table 1 — Multipliers for the 1979 revaluation of fixed assets

| Year of acquisition/ planting | Building, construction and its supplementary facilities | Machinery, heavy equipment and accessories | Transportation means and office equipment | Ships, airplanes and their equipment | Plantations, hardy plants of more than two years old |
|---|---|---|---|---|---|
| 1960 | 7.6 | 5.3 | 2.9 | 5.2 | 3.1 |
| 1961 | 7.6 | 5.3 | 2.9 | 5.2 | 3.1 |
| 1962 | 7.6 | 5.3 | 2.9 | 5.2 | 3.1 |
| 1963 | 7.6 | 5.3 | 2.9 | 5.2 | 3.1 |
| 1964 | 7.6 | 5.3 | 2.9 | 5.2 | 3.1 |
| 1965 | 7.6 | 5.3 | 2.9 | 5.2 | 3.1 |
| 1966 | 7.6 | 5.3 | 2.9 | 5.2 | 3.1 |
| 1967 | 7.6 | 5.3 | 2.9 | 5.2 | 3.1 |
| 1968 | 5.7 | 3.6 | 2.9 | 3.1 | 2.5 |
| 1969 | 3.2 | 2.1 | 2.9 | 2.6 | 2.0 |
| 1970 | 2.7 | 1.9 | 2.9 | 2.2 | 1.8 |
| 1971 | 2.4 | 1.8 | 2.9 | 1.9 | 1.7 |
| 1972 | 2.3 | 1.6 | 2.6 | 1.8 | 1.5 |
| 1973 | 2.2 | 1.5 | 2.0 | 1.7 | 1.4 |
| 1974 | 1.7 | 1.4 | 1.7 | 1.5 | 1.3 |
| 1975 | 1.4 | 1.3 | 1.4 | 1.4 | 1.2 |
| 1976 | 1.3 | 1.3 | 1.3 | 1.3 | 1.2 |
| 1977 | 1.2 | 1.2 | 1.2 | 1.2 | 1.1 |
| before 15-11-78 | 1.1 | 1.1 | 1.1 | 1.1 | 1.0 |
| after 15-11-78 | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 |

## Table 2 — Central Government revenues (millions of rupiahs)

| | 1974/1975 Actual | 1975/1976 Actual | 1976/1977 Actual | 1977/1978 Actual | 1978/1979 Original Budget | 1979/1980 Original Budget |
|---|---|---|---|---|---|---|
| 1. Normal revenue | 1,753,663 | 2,241,850 | 2,905,990 | 3,535,454 | 3,970,000 | 5,440,500 |
| 1. Direct taxes | 1,228,621 | 1,592,028 | 2,046,613 | 2,511,332 | 2,808,000 | 4,113,100 |
| – Income tax | 43,257 | 61,725 | 84,179 | 104,566 | 138,300 | 144,600 |
| – Corporation tax | 91,163 | 128,136 | 127,249 | 169,532 | 195,300 | 228,200 |
| – Corporate tax on oil | 973,100 | 1,249,059 | 1,619,400 | 1,948,700 | 2,067,400 | 3,344,800 |
| – Withholding tax (MPO) | 83,265 | 97,308 | 148,396 | 201,750 | 312,000 | 289,900 |
| – Land tax | 27,977 | 34,600 | 42,150 | 52,473 | 57,500 | 64,100 |
| – Others | 9,859 | 21,200 | 25,239 | 34,311 | 37,500 | 41,500 |
| 2. Indirect taxes | 458,397 | 539,413 | 740,903 | 880,505 | 1,042,700 | 1,160,100 |
| – Sales tax | 84,899 | 119,231 | 162,284 | 203,379 | 259,200 | 277,400 |
| – Sales tax on imports | 68,904 | 72,442 | 102,241 | 114,556 | 132,100 | 112,800 |
| – Excises | 74,020 | 97,307 | 130,658 | 181,859 | 225,100 | 298,500 |
| – Import duties | 160,635 | 174,011 | 257,407 | 286,944 | 326,200 | 280,600 |
| – Export tax | 70,300 | 61,600 | 61,700 | 81,250 | 82,400 | 172,800 |
| – Net profit from oil | – 15,933 | – 1,078 | 15,899 | – | – | – |
| – Others | 15,190 | 15,900 | 10,714 | 12,517 | 17,700 | 18,000 |
| 3. Non-tax receipts | 66,645 | 110,409 | 118,474 | 143,617 | 119,300 | 167,300 |
| 2. Development receipts | 232,046 | 491,639 | 783,800 | 773,368 | 856,300 | 1,493,500 |
| 1. Program aid | 36,146 | 20,269 | 10,200 | 35,800 | 45,100 | 64,700 |
| 2. Project aid | 195,900 | 471,370 | 773,600 | 737,568 | 810,200 | 1,428,800 |
| Total | 1,985,709 | 2,733,489 | 3,689,790 | 4,308,822 | 4,826,300 | 6,934,000 |

## Table 3

**Revenue from direct taxes** [1]
**1969/1970 – 1979/1980**
in 1,000,000,000 rupiah

| Budget year | Amount | Increase Amount | Increase In percentage |
|---|---|---|---|
| Repelita I: | | | |
| 1969/1970 | 43.2 | – | – |
| 1970/1971 | 52.9 | + 9.7 | + 22.5 |
| 1971/1972 | 68.5 | + 15.6 | + 29.5 |
| 1972/1973 | 103.3 | + 34.8 | + 50.8 |
| 1973/1974 | 160.4 | + 57.1 | + 55.3 |
| Repelita II: | | | |
| 1974/1975 | 255.6 | + 95.2 | + 59.4 |
| 1975/1976 | 343.0 | + 87.4 | + 34.2 |
| 1976/1977 | 427.2 | + 84.2 | + 24.5 |
| 1977/1978 | 562.6 | + 135.4 | + 31.7 |
| 1978/1979 [2] | 740.6 | + 178.0 | + 31.6 |
| Repelita III: | | | |
| 1979/1980 [3] | 768.3 | + 27.7 | + 3.7 |

1) Tax on oil excluded
2) Annual budget
3) Draft annual budget
*Source:* Financial Statement and Annual Budget 1979/1980.

## Table 4

**Revenue from indirect taxes** [1]
**1969/1970 – 1979/1980**
in 1,000,000,000 rupiah

| Budget year | Amount | Increase Amount | Increase In percentage |
|---|---|---|---|
| Repelita I: | | | |
| 1969/1970 | 131.6 | – | – |
| 1970/1971 | 179.4 | + 47.8 | + 36.3 |
| 1971/1972 | 191.3 | + 11.9 | + 6.6 |
| 1972/1973 | 222.3 | + 30.9 | + 16.2 |
| 1973/1974 | 375.3 | + 153.1 | + 68.9 |
| Repelita II: | | | |
| 1974/1975 | 474.3 | + 99.0 | + 26.4 |
| 1975/1976 | 540.5 | + 66.2 | + 14.0 |
| 1976/1977 | 725.0 | + 184.5 | + 34.1 |
| 1977/1978 | 880.5 | + 155.5 | + 21.4 |
| 1978/1979 [2] | 1.042.7 | + 162.2 | + 18.4 |
| Repelita III: | | | |
| 1979/1980 [3] | 1.160.1 | + 117.4 | + 11.3 |

1) Tax on oil excluded
2) Annual budget
3) Draft annual budget
*Source:* Financial Statement and Annual Budget 1979/1980

## Table 5

**Revenue from oil**
**1969/1970 – 1979/1980**
in 1,000,000,000 rupiah

| Budget year | Corporation tax on oil | Other receipt from oil | Increase Amount | Increase Amount | Increase In percentage |
|---|---|---|---|---|---|
| Repelita I: | | | | | |
| 1969/1970 | 48.3 | 17.5 | 65.8 | – | – |
| 1970/1971 | 68.8 | 30.4 | 99.2 | + 33.4 | + 50.8 |
| 1971/1972 | 112.5 | 28.2 | 140.7 | + 41.5 | + 41.8 |
| 1972/1973 | 198.9 | 31.6 | 230.5 | + 89.8 | + 63.8 |
| 1973/1974 | 344.6 | 37.6 | 382.2 | + 151.7 | + 65.8 |
| Repelita II: | | | | | |
| 1974/1975 | 973.1 | – 15.9 | 957.2 | + 575.0 | + 150.4 |
| 1975/1976 | 1,249.1 | – 1.1 | 1,248.0 | + 290.8 | + 30.4 |
| 1976/1977 | 1,619.4 | 15.9 | 1,635.3 | + 387.3 | + 31.0 |
| 1977/1978 | 1,948.7 | – | 1,948.7 | + 313.4 | + 19.2 |
| 1978/1979 [1] | 2,067.4 | – | 2,067.4 | + 118.7 | + 6.1 |
| Repelita III: | | | | | |
| 1979/1980 [2] | 3,344.8 | – | 3,344.8 | + 1,277.4 | + 61.8 |

1) Annual Budget
2) Draft Annual Budget

## Table 6
**Revenue from non-tax receipts**
**1967/1970 – 1979/1980**
in 1,000,000,000 rupiah

| Budget year | Amount | Increase Amount | Increase In percentage |
|---|---|---|---|
| Repelita I: | | | |
| 1969/1970 | 3.1 | – | – |
| 1970/1971 | 13.1 | + 10.0 | + 322.6 |
| 1971/1972 | 27.5 | + 14.4 | + 109.9 |
| 1972/1973 | 34.6 | + 7.1 | + 25.8 |
| 1973/1974 | 49.8 | + 15.2 | + 43.9 |
| Repelita II: | | | |
| 1974/1975 | 66.6 | + 16.8 | + 33.7 |
| 1975/1976 | 110.4 | + 43.8 | + 65.8 |
| 1976/1977 | 118.5 | + 8.1 | + 7.3 |
| 1977/1978 | 143.6 | + 25.1 | + 21.2 |
| 1978/1979 1) | 119.3 | – 24.3 | – 16.9 |
| Repelita III: | | | |
| 1979/1980 2) | 167.3 | + 48.0 | + 40.2 |

1) Annual Budget
2) Draft Annual Budget
The term non-tax receipts includes receipts from Departments and other Government institutions for services rendered, sale of agrarian produce, cattle, sale of houses, court fees, repayment from loans, profit from state-run enterprises and government owned banks.

## Table 7
**Income from revenue according to draft annual budget 1979/1980**
in 1,000,000,000 rupiah

| | | | |
|---|---|---|---|
| I | Direct taxes | | 4,113.1 |
| | Individual income tax | 144.6 | |
| | Corporate income tax | 228.2 | |
| | Corporation tax on oil | 3,344.8 | |
| | MPO (withholding taxes) | 289.9 | |
| | IPEDA (land tax) | 64.1 | |
| | Others | 41.5 | |
| II. | Indirect taxes | | 1,160.1 |
| | Sales tax | 277.4 | |
| | Sales tax at importation | 112.8 | |
| | Excise | 298.5 | |
| | Import duty | 280.6 | |
| | Export tax | 172.8 | |
| | Others | 18.0 | |

*Source:* Extract from Financial Statement and Annual Budget 1979/1980.

## Table 8
**State revenue, semester I 1977/1978 – 1978/1979**
in 1,000,000,000 rupiah

| | 1977/1978 semester I | 1978/1979 semester I 1) | Increase in percentage |
|---|---|---|---|
| Direct tax | 1,230.8 | 1,327.7 | 7.9 |
| Indirect tax | 392.9 | 473.8 | 20.6 |
| Non tax | 53.8 | 88.2 | 63.9 |
| | 1,677.5 | 1,889.7 | 12.6 |

1) Estimates

## Table 9
**Direct taxes, semester I 1977/1978 – 1978/1979**
in 1,000,000,000 rupiah

| | 1977/1978 semester I | 1978/1979 semester I 1) | Increase in percentage |
|---|---|---|---|
| Individual income tax | 46.0 | 50.3 | 9.3 |
| Corporate income tax | 62.8 | 74.6 | 18.8 |
| Corporation tax on oil | 983.1 | 1,050.5 | 6.9 |
| MPO (withholding tax) | 97.1 | 102.9 | 6.0 |
| IPEDA (land tax) | 27.8 | 33.1 | 19.1 |
| Others | 14.0 | 16.3 | 16.3 |
| | 1,230.8 | 1,327.7 | 7.9 |

1) Estimates

## Table 10
**Indirect taxes, semester I 1977/1978 – 1978/1979**
in 1,000,000,000 rupiah

| | 1977/1978 semester I | 1978/1979 semester I 1) | Increase in percentage |
|---|---|---|---|
| Sales tax | 81.0 | 92.8 | 14.6 |
| Sales tax at importation | 53.6 | 62.7 | 17.0 |
| Excise | 83.0 | 112.4 | 11.4 |
| Import duties | 131.0 | 145.9 | 39.5 |
| Other proceeds from oil | 0.3 | – | – |
| Others | 6.0 | 7.0 | 16.7 |
| | 392.9 | 473.8 | 20.6 |

1) Estimates

## Table 11
**Local Government revenue in Special District Jakarta in 1977/1978**
in million rupiah

| | |
|---|---|
| Casino tax (tax on gambling) | 11,000 |
| SWP 3 D (motor vehicle tax) | 9,300 |
| BBN (motor vehicle transfer tax) | 7,600 |
| Entertainment tax | 3,000 |
| Development Tax I | 2,700 |
| Alien Tax | 600 |
| Surcharge on net wealth tax | 100 |
| Advertisement tax | 200 |
| Slaughter tax | 60 |
| Radio tax | 50 |
| Non-motor vehicle tax | 2 |
| Other taxes and fines | 197 |
| Total | 34,809 |

About one third of the revenue from taxes in the Special District of Jakarta is obtained from the tax on gambling paid by the casinos. Notwithstanding strong opposition by the public to the maintenance of casinos, the tax on gambling remains the sole permanent source of local revenue necessary for the maintenance and development of the infrastructure of the Special District of Jakarta.

# Solomon Islands: **BUDGET 1980**

Extracts from the Budget Speech 1980 which was pronounced on November 15, 1979

To carry out the recurrent operations of the national government, and to finance the development projects that are now running or planned to start in 1980, we estimate that we shall require to spend a total of just over $ 56 million.

Of this total, $ 27 million will be for the Recurrent Budget end $ 29 million for the Development Budget.

Detailed estimates of expenditure have been in the hands of Members for three weeks. I hope very much that the House will have received the report of the Public Expenditure Committee, before we reach the Committee of Supply to examine the Draft Estimates in detail. The unwillingness of some Honourable Members to play a full part in the work of this Committee is disappointing, but I am sure I speak for the House in thanking the Chairman and those Members who have taken part, for their work in scrutinising the Draft Estimates, examining Accounting Officers, and preparing the report.

Turning now to the revenue required to finance the Budget, I remind the House of our two-pronged policy that

- we should move as quickly as possible to self-sufficiency in funding the recurrent budget
- we should steadily increase our contribution of local funds to the development budget.

With that in mind, we aim to raise about $ 26.5 million of local revenues in 1980, that is $ 7.25 million more than we originally budgetted for in 1979, and $ 6.4 million more than we now expect 1979 to produce. This increase, of about one-third, represents a major step in self-reliance and mobilising our own finances. About half of it will come from the "natural" growth of various forms of revenue; and about half will come from the net result of changes to direct and indirect taxation.

Export duties will be unchanged except for copra export duty. This will be changed from a c.i.f. basis to f.o.b. and the free limit before duty will be raised from $ 150 to $ 180. The effect of this change is to reduce the probable tax to be paid by the copra industry in 1980 from $ 2 million to $ 125 million. The saving to the producers is about three quarters of a million dollars. Companies of course will pay tax on their increased profits, but smallholders will benefit in full through the increased prices the Copra Board will be able to pay, worth about $ 25 a ton at expected price levels.

Import duties will be increased on about forty items. I will mention here only the most important ones; full details are being released by the Controller of Customs and Excise at eleven o'clock today. The Order amending the tariff came into effect this morning.

Duty on beer is increased from 47.5 cents to 55 cents per litre, that is an increase just under three cents a bottle of the most popular brand. A similar increase, from $ 5.20 to $ 6.50 per litre, is made in the duty on spirits.

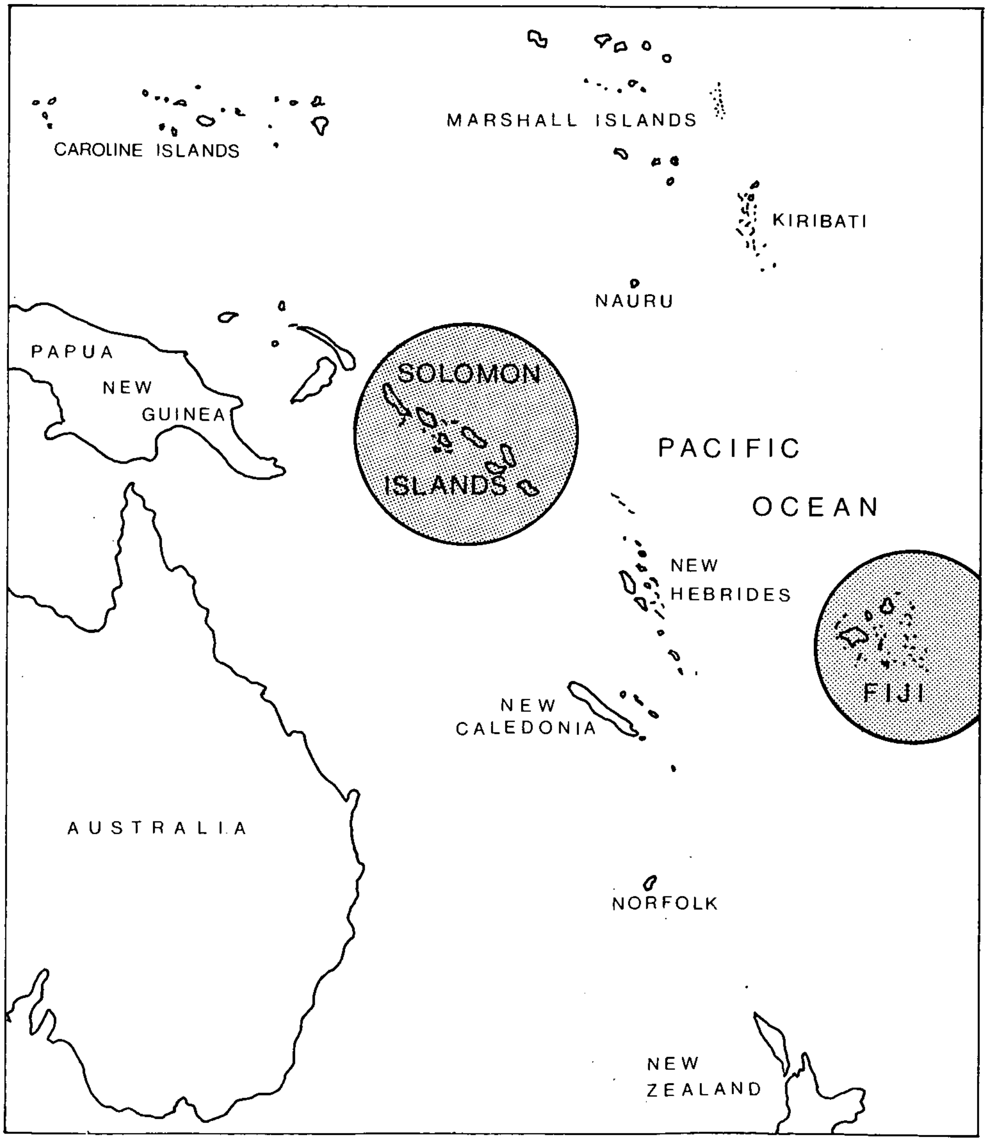
The tariff on cigarettes and tobacco is raised from $ 17.50 per kilogram to $ 22.50. This means an increase in duty of 12½ cents on a packet of 20 cigarettes, and a similar amount on imported tobacco. The excise duty on locally-manufactured tobacco is not changed.

Duty on sugar is increased from the present 3.3 cents per kilogram to 10 cents. The tariff on imported sweets, confectionery and soft drinks is raised to 50 percent.

I come now to income tax, on personal and business incomes. Next week I will be presenting to the House the Income Tax (Amendment) Bill, 1979. This Bill seeks to make a number of important changes to our income tax structure. Most of these arise from the Report of the Working Party on Income Tax, which members have received. We shall be debating the Bill, in the normal way, and I will go into more detail at that time.

Here I will mention only those changes that have an important impact on revenue, and people's incomes, in the 1980 Budget.

The level of income at which personal income tax starts to be paid will be raised from $ 600 to $ 1,200 for single persons, and from $ 1,200 to $ 2,400 for a married couple. This change is intended to recognise the wide family responsibilities of



## HIGHLIGHTS OF SOLOMON ISLANDS TAXATION

**General:** The scope of income tax is limited to income derived or received from the Solomon Islands. A "pay as you earn" system operates for both employment and business income.

**Company tax:** The rate for both private and public companies is 30 percent. Shareholders are liable to individual income tax on dividends received but receive a tax credit of 30 percent of the gross dividend thereby ensuring that company profits are taxed on a once-only basis. There is no undistributed profits tax.

**Personal tax:** Total income less personal deductions is subject to a progressive rate commencing at 11 percent for the first $ 360, which rate increases by 1 percent for every successive $ 360 of chargeable income until a maximum of 40 percent is reached on all chargeable income in excess of $ 10,440. Personal deductions are:

| | |
|---|---|
| *Basic personal allowance –* | $ 600, or $ 900 for a widow or widower with a dependent child. |
| *Wife allowance –* | $ 600. |
| *Child allowance –* | $ 120 for each child up to four in number. |
| *Education allowance –* | the cost of the full time education of a dependent child up to four in number with a maximum of $ 1,200 in respect of each child. |
| *Life insurance and superannuation allowance –* | the actual cost of contributions up to a maximum of 20 percent of total income, less any tax free contribution by the employer. |
| *Medical allowance –* | actual cost of medical treatment. |
| *Passages for medical treatment –* | actual cost. |
| *Passages for school children –* | actual cost with maximum of two visits per year for each child up to four. |
| *Holiday passages for persons not domiciled in Solomon Islands –* | actual cost with maximum of two single journeys between Solomon Islands and country of domicile. |
| *Home mortgage interest relief –* | actual cost to extent that mortgage does not exceed $ 15,000. |
| *Alimony and maintenance allowance –* | actual cost apportioned on basis of world income to Solomon Islands income. |

**Withholding tax on non-resident income:**

| | |
|---|---|
| Interest, know how payments, royalties, insurance premiums | 15 percent |
| Income from contracting | 6 percent |
| Income from shipping or air transportation subject to Sec. 8 Income Tax Act | 30 percent |

**Local tax:** The local councils established under the Local Government Ordinance have a wide range of rating powers including basic rates and rates on possessions and property. Basic rates vary between $ 1 and $ 60 a year and are generally at a uniform amount per capita, although some councils have introduced graduated rates according to the occupation or assessed income of the ratepayer. Basic rates are payable by all persons of or above the age of 18 and resident within the area of a council's authority unless generally or specifically exempted. Only the Honiara Town Council has introduced general property rates based on the unimproved value of rateable land in the town. The current property rate is seven and a half percent.

Solomon Islands income earners. The change will remove the burden of income tax from about seven thousand people, all Solomon Islanders, who pay tax at present. It will reduce the number of persons paying personal income tax in 1980 to about three thousand, of whom about two thousand will be nationals and the remainder expatriates. This change will provide an immediate cash benefit to almost all taxpayers, but the proportionate benefit is greatest for married people on income between $ 2,000 and $ 3,000 a year.

In making this change, together with the reduction in copra export duty, we are deliberately opening up greater opportunities for the Provincial Assemblies to adopt a more progressive attitude to taxation through basic rate collection from people earning up to $ 100 or so a month. It is very important that Provincial Governments, with their much simplier collection methods and direct contact with taxpayers, do take these opportunities to increase their own revenues and reduce to some extent their dependence on national government grants. This change will also greatly ease the pressure on the Income Tax Division, and enable much more attention to be given to making sure that companies and people on higher incomes, where payment by each taxpayer is significant, do pay all the tax they ought to pay.

At the same time as the starting point for income tax is raised, we intend to increase the starting rate to 15 cents in the dollar, and take it up in 2 cent steps for each thousand dollars of income to a new maximum rate of 45 cents in the dollar, which will be reached on taxable incomes of $ 17 to $ 18,000 dollars a year. Revised valuations will be introduced, for tax purposes, of housing supplied by employers, so as to keep a fair balance between those who receive subsidised housing and those who do not.

Business tax rates will also be changed. The basic rate will go up from 30 percent to 35 percent, and a new rate of 45 percent will apply to companies operating here but not incorporated here, that is, local branches of overseas companies.

Tax on dividends will be greatly simplified. Under the proposed changes, a withholding tax of 20 percent will be paid on dividends paid to shareholders resident here, and 35 percent on dividends to overseas shareholders. The company itself will pay tax at 35 percent on the profits that are not distributed as dividends.

The increased revenue from these changes will go a long way towards balancing the annual revenue reduction of $ 0.5-0.75 million that we estimate will result from the changes in the personal income tax. The new rates of company tax are fair and reasonable, and we believe strike a good balance between the needs of companies and the needs of the wider community.

In this context, I am pleased to inform the House that good progress has been made in talks with our co-investor in the oil palm project, CDC, about changing the taxation arrangements for SIPL. This project has performed very well indeed, thanks to skilled management, hard work, and favourable market prices. Under the proposed new arrangement, SIPL will start to pay tax four years earlier than it otherwise would have done, yielding a substantial benefit to government revenues during the coming Development Plan period. It is this which has mainly enabled me to make the major reduction in copra export duty I announced a few minutes ago. As a result of these talks we expect to make an agreement with CDC that will recognise the valuable role CDC can play in Solomon Islands national development, in partnership with Solomon Islands interests, and pave the way for further CDC investment on appropriate terms.

Mr. Speaker, the changes I have described in taxation, together with the growth of the monetary economy which we expect to take place, are estimated to bring in tax revenues of between \$ 17 and \$ 18 million in 1980, about two-thirds of our estimated recurrent revenue requirements. This represents an increase in tax revenues of \$ 4 million or 30 percent above the revised estimates for this year, and is three and a half times greater than in 1975, the first year of the current National Development Plan.

# Fiji: BUDGET SPEECH 1980

Extracts from the Budget Speech 1980 pronounced on November 16, 1979 by the Minister of Finance, Mr. Charles Walker.

It has been widely recognised in Government and in the private sector, and also strongly endorsed by the Financial Review Committee that an Economic Development Board should be established to give direction and thrust to investment and job creation. A Tripartite Forum Committee has been meeting to define the role and powers of such a Board. They are expected to make their recommendations shortly and legislation will be introduced early in 1980 to set up the Board. This move will give much needed impetus to an area that has tended to lag and which in the next few years will become very critical.

Arising out of a thorough evaluation of the Financial Review Committee's recommendations Government will implement the following taxation measures:

1. Allowance for the first child and second child, without income limitation, will be increased from \$ 130 to \$ 200;
2. Maximum deduction for interest on housing loans will be raised from \$ 200 to \$ 500;
3. Taxpayers earning less than \$ 8,000 a year will be given a rebate of 12½ percent on new savings for home ownership;
4. Rates of normal tax on companies will be raised as follows:
   (1) non-resident companies from 37½ to 42½ percent;
   (2) non-resident life insurance companies from 22½ to 27½ percent; and
   (3) every other company from $30^5/_6$ to 35 percent;
5. Write-off of depreciation on assets acquired after 31st December 1979, and used in a business, will be changed to a straight-line method;
6. Profit from sale of a business asset being replaced will be available for set-off against the cost of replacement asset, at the option of the taxpayer;
7. Initial depreciation allowance for plant and machinery will be raised from 20 to 30 percent;
8. Consideration is being given to exempt from tax bonus shares issued out of trading profit;
9. Gift duty exemption will be increased to \$ 10,000, and spouse to spouse gift will be exempted from duty subject to certain safeguards against tax avoidance;
10. Export incentives allowance for timber sales will be equal to 10 percent of the f.o.b. value of arm's length sales, with a maximum of 50 percent of the chargeable income;
11. Method of claiming export incentives relief will be simplified so that separate records need not be maintained, and export profit to be based on export sales over total sales of total profit;
12. Withholding tax on royalty payments will be increased from 15 to 25 percent;
13. Deductions for the Fiji National Provident Fund contribution by employers will be raised from \$ 600 to \$ 1,000;
14. Expatriate employees will be able to join the Fiji National Provident Fund but on withdrawal of contributions must comply with current legislation;
15. Period of tax exemption for co-operatives will be increased from 5 to 8 years, and amounts transferred to reserve for expanding the business will be allowable deductions for tax;
16. Hotel aid will continue to apply to expanding hotels and concessionary treatment will be accorded where in-

### HIGHLIGHTS OF FIJI INCOME TAXATION

Income taxation consists of (i) basic tax, (ii) normal tax and (iii) a number of withholding taxes.

| | | |
|---|---|---|
| **Basic tax:** | This is levied on income before deduction of any allowance of individuals and companies. Individuals whose income does not exceed \$ 600 are exempt. | |
| **Normal tax:** | This is levied on individuals whose income exceeds \$ 600 at progressive rates ranging from 7.5 percent for the first \$ 600 to 50 percent for income exceeding \$ 24,000. Companies are also subject to normal tax at varying flat rates as follows: | |
| | – standard rate | $30^5/_6$ % |
| | – non-resident shipping companies | 2 % |
| | – non-resident mutual insurance companies | 22.5 % |
| | – other non-resident companies | 37.5 % |
| **Withholding taxes:** | Dividends distributed by a Fiji company to a resident individual | 5 % |
| | Dividends distributed by a Fjji company to a resident corporation | 0 % |
| | Dividends distributed by a Fiji company to non-resident individuals and corporations | 15 % |
| | Royalties paid by a Fiji company to non-resident individuals and corporations | 15 % |
| | Interest paid by a Fjji resident to non-resident inviduals and corporations | 10 % |

vestment allowance is not utilised in full within 5 years;
17. Estate duty exemption will be raised.

In addition to implementing the foregoing recommendations of the Financial Review Committee, with minor modifications where considered appropriate, following measures will be taken to give further impetus to development:

18. Film-makers will be encouraged by special tax treatment dependent on the amount to be spent in Fiji; and
19. Third schedule income tax concession will be raised on sliding scale dependent on the number of employees, with a maximum relief equivalent to 25 percent of the paid up capital where over 50 employees are engaged by the enterprise, and minimum tax concession will be raised from $ 5,000 to $ 8,000.

To remove an anomaly which exists in the legislation:

20. A 15 percent withholding tax will be levied on all film hire paid to non-resident film suppliers.

Netting out all the above means an overall loss in revenue of about $ 100,000. The aim has been to provide some relief through the increased child allowance, inject incentives for greater savings and inducement for greater investment for job creation. No doubt there will be other views on what could or should be done but these are significant measures.

I should mention that when considering the Financial Review Committee Report, a number of tax recommendations could not be accepted by Cabinet. One was that Fiji National Provident Fund contributions should be taxed. Government has also not agreed that the income derived by a wife from her assets, or a salary or wage received from a business which is conducted or controlled by her husband should not be aggregated with husband's income. The recommendation would encourage income splitting among families and other tax avoidance schemes; it would be hard for the Commissioner of Inland Revenue to counter such avoidance schemes without a large increase in staff.

On deemed distribution and self-employed taxpayers, the Committee made two recommendations. The first was all companies should be allowed to retain profits without dividends being paid provided the profits are reinvested in the business. The short answer to this is that the Income Tax legislation adequately covers this point and we see no reason to change the existing law.

The second recommendation was self-employed taxpayers be taxed only on their personal spendings provided the minimum amount to be taxed be set at 60 percent of their income after tax. The immediate loss of revenue arising from the implementation of this proposal would exceed $ 8,600,000. If implemented the benefit would accrue to only a very small sector of the community, which I might add, would mainly include taxpayers who are already wealthy in our context.

On group assessment Government has not agreed with the Committee's recommendation that companies with 75 percent common shareholders be taxed as one unit. The Committee did not give any reasons for making this recommendation, but nevertheless, we consider that there would be little economic benefit accruing to Fiji should such a system be implemented. It could, in fact, have the reverse effect, in that such companies would not accept further equity investment by others for fear of being denied the benefit of group assessments.

Turning now to customs and excise, Government has decided to restore revenue from this source to the level obtained prior to 1974 by increasing taxes and excise on some traditional items and introducing new items.

One of our difficulties when trying to raise revenue from imported goods is that the burden tends to fall hardest on a limited number of items. We have been guided this year by the advice given by the Financial Review Committee and the measures we have taken are based on their lists.

Importation of cars and other passenger vehicles will continue to be under licence. Total import quotas for both classes of vehicles will remain unchanged, that is 1,100 units and 300 units respectively. In addition, goods vehicles of a gross unladen weight of two tonnes and less designed primarily for transport of goods, will be brought under annual quota. The 1980 quota for this class of vehicle is 850.

To provide additional incentives to local substitution for imports, help conserve foreign exchange and to broaden our indirect tax base, we are immediately raising duties on the following items:

1. Meat fresh or frozen; raised from 5 to 10 percent.
2. Fowls, ducks, in pieces and poultry liver fresh etcetera: increased by 15 percent to 45 percent.
3. Geese, turkeys etcetera: increased by 35 percent to 45 percent.
4. Butter: raised from nil to 10 percent.
5. Honey natural and artificial: raised by 20 percent to 45 percent.
6. Vegetables frozen, preserved and dried: raised by 25 percent to 30 percent.
7. Dried leguminous vegetables: raised from nil to 5 percent.
8. Fruits fresh, fruits preserved by freezing and fruits dried etcetera: increased by 25 percent to 30 percent.
9. Brown rice: raised from nil to 5 percent.
10. Polished rice: raised from nil to 10 percent.
11. Sausages etcetera: increased by 45 percent to 50 percent.
12. Canned fowls and ducks: increased by 5 percent to 45 percent.
13. Ice cream: increased by 25 percent to 35 percent.
14. Import duty of 15 percent has been increased to 40 percent for textile fabrics which are so processed that they are clearly suitable for conversion by a minor operation into made up articles.
15. Garments: increased by 10 percent to 55 percent.
16. Corsets, brassiers etcetera: increased by 15 percent to 55 percent.
17. Table and household linen: increased by 10 percent to 55 percent.
18. Parts of hats and headgear: increased by 27½ percent to 60 percent.
19. Headgear and hats: increased by 22½ percent to 60 percent.

In addition Customs duty on bulk tea and wheat and meslin has been raised from nil to 5 percent. It will be noted that we are levying Customs duty on imports of bulk tea and wheat rather than making packaged tea and the products of wheat excisable.

Items on which duties are raised for revenue purposes are:

1. Imported Beer: fiscal duty of $ 1.00 per litre is increased to $ 1.05.
2. Spirits: duties of $ 6.08 per litre on spirits containing 57.12 percent or less alcohol by volume and $ 10.64 per litre of spirits containing more than 57.12 percent alcohol by volume have been increased to $ 6.58 per litre and $ 11.52 per litre respectively.
3. Imported Cigarettes, Cigars and Tobacco: duties of $ 21.70 per kilogram on cigars and cheroots, $ 21.15 on cigarettes and $ 19.30 tobacco have been increased to $ 22.40, $ 21.85 and $ 20.00 per kilogram respectively.
4. The existing duty free list has also been extended by the addition of clocks, cigarette lighters, figurines of ceramics, audio amplifiers, speakers and household pewter ware. Duty has been reduced to 5 percent Fiscal and 5 percent Customs.

Opportunity has also been taken to regularise concessions granted to duty free shops at International Airports by suitably amending Code 214.

Excise duties have also been raised to yield additional revenue. The following changes become effective immediately:

1. Local Beer: increased from 30 cents per litre to 32.5 cents per litre.
2. Local Cigarettes: currently 10.395 cents per 10 cigarettes with local tobacco content and 16.52 per 10

cigarettes with imported tobacco content, increased to 13.60 cents and 18.05 cents respectively.

3. Local Tobacco: currently $ 9.15 per kilogram with local tobacco content and $ 14.54 per kilogram with imported content increased to $ 9.88 per kilogram and $ 15.94 per kilogram respectively.
4. Matches: increased to $ 1.44 per gross from 15 cents per gross. Since the manufacture of matches started in Fiji in 1966, the excise duty on matches has remained at 15 cents per gross. On the other hand the import duty on matches containing not more than 60 matchsticks per box is presently $ 3.14 per gross.

Honourable Members will recall my predecessor's statement last year of Government's policy to progressively levy excise duties on local manufactures so as to ensure a wider revenue base. In line with this policy the following new items are being made excisable:

1. Ice cream: an excise rate of duty of 5 cents per litre.
2. Aerated Waters: an excise rate of duty of 4 cents per litre.
3. Cement: an excise rate of duty of $ 1.00 per tonne.
4. Toilet Paper: an excise rate of duty of 2 cents per roll.
5. Soap and Detergents: an excise rate of duty of 5 cents per kilogram.

The impact of these measures on the Consumer Prices Index has been evaluated and I am assured it would not be increased by more than one percent in a full year.

All these new measures together will yield a total of about $ 4.3 million, which added to the net loss of about $ 100,000 from income tax will mean a net additional yield of $ 4.2 million. This will enable us to maintain a balance in the operating budget for 1980.

There is no question that another "cycle" of hard economic times has begun with the international economy facing a slow down of economic growth and inflation endemic and increasing. And it is upon us just as we were energing out of the 1974 oil crisis and recession. None of us, neither the Government nor the responsible Opposition nor the country at large can duck our allotted responsibilities. The Budget I have presented is clear evidence that Government is prepared to take the first step and balance its operating budget; it is clear evidence that Government has noted the views of the Financial Review Committee and will have to move forward cautiously making adjustments so as to be sure to better cope with the difficult times ahead.

Mr. Speaker, Sir, I commend the Bill to the House.

# Steuer und Studium

The Editors received from the German publishing house "Verlag Neue Wirtschafts-Briefe" the following announcement with respect to a new tax journal which is in particular aimed at assisting persons being trained to become tax inspectors or tax counsel. Since this announcement will be of interest primarily to our German readership the text of the announcement is reproduced in German.

*Ab 1. April 1980 erscheint im Verlag Neue Wirtschafts-Briefe eine neue Zeitschrift: Steuer und Studium. Steuer und Studium ist eine Zeitschrift für die Aus- und Fortbildung im Steuerrecht. Sie berücksichtigt in der Konzeption besonders pädagogische Gesichtspunkte und dient dem Lernenden gleichzeitig als Repetitorium. Die Zeitschrift will vorhandene Lehrbücher wirksam ergänzen. Wer Steuer und Studium regelmässig liest, ist während seiner Ausbildung und zur bevorstehenden Prüfung bestens vorbereitet.*

*Steuer und Studium ist speziell konzipiert für die Ausbildung der künftigen Steuerinspektoren an den Fachhochschulen für Finanzen. Gleichzeitig wendet sie sich an die Personen, die sich auf die Steuerberaterprüfung vorbereiten. Auch der Student an der Hochschule sollte Steuer und Studium lesen. Darüber hinaus spricht Steuer und Studium den Mitarbeiter in der Steuerpraxis oder im Betrieb an, der etwas für seine Weiterbildung tun will und sich z.B. auf die Bilanzbuchhalterprüfung vorbereitet.*

*Erfahrene Dozenten, die an Fachhochschulen für Finanzen der Bundesrepublik und an Steuerschulen tätig sind, sowie Fachleute aus der Steuerpraxis schreiben für Steuer und Studium. Interessierte Leser können ein Probeheft beim NWB Verlag, Postfach 16 20, 4690 Herne 1, anfordern.*

# Malaysia: BUDGET 1980

Extract from the Budget Speech pronounced by the Minister of Finance Yang Berhormat Mulia Tengku Razaleigh on October 18, 1979.

A detailed discussion of the Malaysian tax system appears in the Bureau's publication: TAXES AND INVESTMENT IN ASIA AND THE PACIFIC

However, these strategic goals of increasing economic growth and stepping up Government and private investments, must be directly linked to increasing the national capacity to produce the increasing supplies of especially essential consumer goods, that will be needed, to meet the rising demands of our people. Increased production dampens inflation. Conversely reasonable price stability promotes steady economic growth and improves the standard of living of our people.

### The budget impact

I am therefore presenting to this House a *package of bold budgetary measures* to help ensure the attainment of the 1980 Budget Objectives.

I propose:

(a) A total appropriation of $ 20,724 million for the 1980 Budget - $ 10,868 million for Operating Expenditure and $ 9,856 million for Development Expenditure;
and

(b) A *tax cut* amounting to $ 482 million. This is the biggest tax cut in our history. If we were to include the tax concessions and the subsidies, to Lembaga Letrik Negara and for petroleum products amounting to $ 491 million, the total amount of Government assistance will be $ 973 million.

Operating expenditure alone represents an increase of $ 2,159 million or 24.8 percent over the original 1979 estimates of $ 8,709 million. These high expenditures will enable Government to provide better and wider services to the public. At the same time Government will be able to expand and increase the effectiveness of its implementation capacity for the vast development efforts, programmes and projects, that have been increased under the *Third Malaysia Plan.* Indeed the recent *Operasi Isa Penuh* will be financed from these increases in the Operating Expenditure. This exercise will help establish an even stronger manpower base, for the planning and implementation of the *Fourth Malaysia Plan*, 1981-1985. It will also strengthen the rapidly growing Government machinery to better serve the private sector.

### Retiring gratuities and pensions

In order to maintain and strengthen the Government's capacity to effectively implement the Fourth Malaysia Plan, it is necessary to retain the senior and experienced Government staff. In view of this need I now propose to withdraw the exemption of the tax on retiring gratuity and pension paid to an employee in the public sector who retires before the age of 55.

The exemption of tax on gratuity and pension now will only be given to an employee in both the public and private sectors who retires from employment on reaching the age of 55 or on reaching the compulsory age of retirement specified under any written law. Although the proposal will take effect from assessment year 1980, there is provision to preserve the rights and obligations of employees whose retirements were approved by their employers before today.

### Commodity taxes

As a further measure to expand economic growth I am therefore proposing a major reform in the export commodity tax structure. This reform is to enable producers of primary commodities, particularly rubber, palm oil, and pepper smallholders, and operators of marginal tin mines to benefit from lower taxes which will result in higher disposable income thereby increasing demand and stimulating further economic growth.

The new concept of commodity taxation will be based on a cost plus approach. Under this concept the cost of production of the commodity will be taken into account and the appropriate duties will only be imposed at prices above the prevailing cost of production.

It is discerned that the average cost of production for rubber is 53 sen per pound, tin $ 1,110 per pikul, crude palm oil $ 455 per tonne, and for black and white pepper $ 130 per pikul and $ 160 per pikul respectively.

It is also felt that the duty structure should not, however, create disincentives to the producers. Thus it is proposed that the maximum marginal rate should not exceed 50 percent for all the commodities.

Based on the new concept of taxation, the export duty on rubber will now commence at a price level exceeding 60 sen per pound. When the price exceeds 60 sen but does not exceed 65 sen, duty will be applied at a rate of 20 percent for every sen increase within this price range. Similarly, for every sen increase in price thereafter but not exceeding a price of 70 sen, a rate of 25 percent will be applied. This progression of the marginal rate by 5 percentage points for every 5 sen increase will be applied up to a price of 90 sen above which the maximum marginal rate of only 50 percent will be levied.

As for tin, it is proposed that the duty will apply only at prices exceeding $ 1,200 per pikul. When the price exceeds $ 1,200 but does not exceed $ 1,250, duty will be levied at a rate of 20 percent for every ringgit increase within this price range. Similarly, for every ringgit increase in price thereafter but not exceeding a price of $ 1,300, a rate of 25 percent will be applied. The marginal rate progresses by 5 percentage points for every $ 50 increase thereafter until a price of $ 1,500 after which a maximum marginal rate of 50 percent begins to apply.

In view of the restructuring of the export duty on tin which will benefit the profitable mines more, it is proposed to revise the top marginal rate of tin profits tax from 12½ percent to 15 percent on taxable tin profit which exceeds $ 400,000.

The export duty on crude palm oil is also revised so that the duty is levied only when price exceeds $ 500 per ton. When the price exceeds $ 500 but does not exceed $ 550, duty at a rate of 30 percent will be levied for every ringgit increase within this price range. For every ringgit increase in price above $ 550 but not exceeding $ 600, a rate of 35 percent will be applied. Thereafter the marginal rate progresses by also 5 percentage points for every $ 50 increase in price until a price of $ 700 after which the maximum marginal rate of 50 percent will apply. The present export duty differential of 30 percent between Peninsular Malaysia and Sabah and Sarawak will remain unchanged.

It is also proposed that the by-products of processed palm oil namely palm stearin and palm kernel oil be subject to a nominal duty of 5 percent.

As can be seen the new duty structure for rubber will achieve two main Government objectives. It will reduce the higher tax incidence on the rubber industry vis-à-vis palm oil and it will give the rubber industry a better edge over palm oil in keeping with the Government's dynamic policy on rubber to encourage the expansion of the industry.

As for pepper, duty will only apply at prices exceeding $ 130 per pikul for black pepper and $ 160 per pikul for white pepper. For prices in excess of the threshold levels which I have just mentioned, marginal rates ranging from 10 percent to a maximum of 50 percent will apply.

In order to encourage the development of the spice industry, it is proposed that the export duty on spices other than pepper be abolished.

Hon'ble Members will agree that the private sector can only operate effectively in an environment of business confidence and the availability of, and accessibility to, basic infrastructure facilities. Business confidence is largely a function of political stability and business opportunities. Therefore, at this time of economic slowdown the private sector is particularly encouraged and understandably so, by Government's own initiatives to sustain and increase its own investment.

For this reason, the Budget has provided $ 585 million to improve and expand the telecommunications system. With this allocation, it is expected that the telephone exchange capacity would be increased by about 164,000 lines, underground cable network by 374,000 pairs, trunk and junction circuit by 120,000 circuit miles and the installation of about 80,000 additional direct subscriber exchange lines. This large allocation for telecommunications projects would not only help to overcome some of its present problems, but would also enhance the facilities for investors as well as traders particularly in the Commodity Exchange that will soon be established.

Similarly, $ 581 million will be provided for the expansion of our capacity to supply electricity in order to keep pace with the increase in private investment expansion.

### Individual income tax

The commodity tax reforms and the provision of more efficient basic infrastructure facilities will provide new incentives to the private sector to invest and produce. To ensure that consumers at the same time have the necessary means to avail themselves of the goods and services, the Government is particularly conscious that such demand is effectively backed by sufficient purchasing power in the hands of consumers. I therefore propose to make significant adjustments in the individual income tax structure.

Relief for the individual which currently stands at $ 2,000 is to be revised to $ 5,000. The increase by $ 3,000 consists of a $ 1,000 increase in actual personal relief, another $ 1,000 to replace the present earned income relief and another $ 1,000 to provide relief for dependents. The present personal rebate of $ 60 is also retained.

Wife's relief of $ 1,000 is now proposed to be increased to $ 2,000. The relief for wife's earned income is to be withdrawn but the rebate for wife of $ 30 is to be retained.

Having regard to the increasing cost of education abroad, it is proposed that the allowance for children educated abroad which currently is double the amount of children's relief be now quadrupled.

Currently chargeable income exceeding $ 50,000 but not exceeding $ 75,000 is taxed at a rate of 50 percent while income exceeding $ 75,000 is subject to a rate of 55 percent. With the objective of providing more incentive for work effort, it is proposed to reduce the tax liability on chargeable income exceeding $ 50,000. Under the proposal, chargeable income exceeding $ 50,000 but not exceeding $ 75,000 will be subject to a reduced rate of 45 percent and for income exceeding $ 75,000 but not exceeding $ 100,000, the rate will be 50 percent for income exceeding $ 100,000 the rate will be 55 percent.

For *excess profits tax*, the present exemption limit of $ 75,000 for any person (other than a company) is raised to $ 100,000. Therefore, an individual will be liable to excess profit tax only on chargeable income which exceeds $ 100,000.

### Review of estate duty

At present there are three separate estate duty legislations for the States of Malaysia. It is proposed to unify the three separate legislations as soon as the necessary administrative preparations are finalised. In the meantime, I would like to make the following proposals with a view to making the structure more equitable and improving income redistribution.

(a) The present exemption level of $ 50,000 for the estate of the deceased who died domiciled in Malaysia will now be raised to $ 300,000 in view of present prices and values of houses and other properties so that beneficiaries will be relieved of undue hardship from estate duty liability on estates left to them by the deceased. Thus, only values of estates in excess of $ 300,000 will now be liable to estate duty.

(b) The present provision of 50 percent abatement against estate duty is at the same time withdrawn.

(c) It is also proposed to revise the estate duty structure under which the estate duty liability will be lower under the proposed structure as compared with the existing structure for estates below $ 700,000 in value. For an estate worth more than $ 700,000 the liability will be higher under the proposal compared to the present structure. A cut-off value of $ 700,000 is considered reasonable and justified taking into account the objective of income and property redistribution.

(d) Finally, I propose to raise funeral expenses to $ 3,000.

The proposals I have just mentioned are applicable to Peninsular Malaysia pending extension of the legislation to Sabah and Sarawak.

In addition to the tax measures which I have just proposed, the Government will continue to adopt a flexible monetary policy that would facilitate the growth of domestic demand, particularly private sector demand so as to stimulate economic growth, private investment and employment generation.

The monetary policy will be formulated with the following objectives: to expand money supply and credit to mitigate any recessionary forces which may be transmitted from abroad and to facilitate a sustained growth of economic activity, especially private investment, without aggravating the underlying inflationary forces; to regulate the liquidity situation in order to generate conditions favorable to the stimulation of private demand for credit at reasonable cost; and to ensure that bank credit is distributed equitably among national priority uses.

The construction sector remains one of the most dynamic sectors in the economy. A significant part of its activity has been in the construction of residential houses. At present, housing loans provided by the commercial banks and other financial institutions have a maximum maturity period of up to 15 years. The monthly repayment terms would be eased considerably and placed within the reach of a larger cross section of the lower and middle income groups if the maturity periods were to be extended to 25 years and beyond. To enable the financial institutions to do so in a prudent manner, we need to establish a secondary mortgage market. I have since directed that the feasibility and technical details of an appropriate scheme be undertaken by Bank Negara in consultation with the major financial institutions. Such a scheme, when introduced, would certainly go a long way in ensuring that home ownership will be within the reach of a vast segment of the population and provide a timely boost to construction activity in the 1980s.

### Accelerated depreciation allowance

Hon'ble Members will recall that *accelerated depreciation allowance* comprising an initial allowance of 20 percent and an annual allowance of 80 percent for capital expenditure on plant and machinery was extended in the 1978 Budget to all industries for assessment years 1979 and 1980.

I now propose that the period of offer be extended by 3 more years ending with assessment year 1983.

### Reinvestment allowance

Similarly, in the 1979 Budget, a *reinvestment allowance* of 25 percent of capital expenditure on plant and machinery and on industrial building was offered for assessment years 1980 to 1982 to manufacturing and processing industries. To be in line with the extension of the accelerated depreciation allowance, I propose to extend the period of offer of the reinvestment allowance by another year to end with assessment year 1983.

### Long-term Credit Bank (Bank Kemajuan Perusahaan Malaysia)

When presenting last year's Budget, I had proposed the provision of long-term financial assistance to the ailing shipping industry, so that domestic shipyards could expand and compete internationally in building vessels for export and in undertaking repairs.

Towards this end, Bank Kemajuan Perusahaan Malaysia Berhad was incorporated on August 7, 1979 with an authorised capital of $ 100 million to provide long-term finance to the shipping as well as other industries in Malaysia. Funded jointly by the Federal Government and Bank Negara Malaysia, Bank Kemajuan would assist domestic industries to expand and upgrade their production technology and capacity and to re-finance their export at internationally competitive terms.

The Bank has already launched its ship repairs financing facility. Invoices for ship repairs of domestic and foreign ships would be eligible for financing under this facility for a maximum period of 1 year at concessionary interest rate of 4.5 percent per annum. Bank Kemajuan is currently working on a range of industrial financing schemes, including medium and long-term suppliers' and buyers' credit for the export of ships, machinery, equipment and other capital goods manufactured in Malaysia.

### Tax incentive for inward reinsurance

In encouraging investment we need to provide investment incentives in the *service sector* of the economy as well. This is particularly important since, as in the case of the insurance industry, there is much scope for expansion.

Presently, profits from inward reinsurance business are subject to the company tax rate of 40 percent in Malaysia. In comparison, concessional rates of only 10 percent and 17 percent are levied in some neighbouring countries. Given the heavier tax liability, the insurance industry in Malaysia is constrained from being able to develop the business of inward reinsurance.

I therefore propose to accord preferential tax treatment by reducing the present 40 percent rate applicable to profits from inward reinsurance to 5 percent so that the insurance industry in Malaysia will be able to compete effectively. Dividends paid out of profits from inward reinsurance will be exempt from tax in the hands of shareholders. With lower tax liabilities, domestic insurance companies should be able to quote lower premiums to attract inward reinsurance which should therefore help expand the scope and performance of the insurance industry.

### Tax incentive for reafforestation

It is proposed that the cultivation of timber be encouraged by extending to reafforestation the same tax treatment which presently applies to the planting industry. Cultivated timber will therefore be brought within the definition of "approved crops" in the Income Tax Act. Any expenditure incurred on replanting will be allowed to be deducted against the revenue of the year in which such expenditure is incurred. Further, plant and machinery used in reafforestation will qualify for an increased initial allowance of 60 percent.

### Tax incentive for exports

Manufacturing exports have been increasing at an impressive rate of 20 percent in the last few years. This is the kind of economic trend that needs encouragement especially at this time of global economic slowdown. Our own economic growth could be stimulated and supported by sustaining the good performance of our manufacturing exports. We cannot allow the recession abroad to adversely affect our own long-term industrial and modernisation plans.

I therefore propose to introduce additional incentives to encourage export oriented manufacturing industries by allowing the cost of maintaining sales offices overseas for the promotion of exports to be elibible for additional deductions. Also I propose to replace the present export allowance, with an outright allowance of 2 percent of ex-factory value of all export sales, and an additional 10 percent on the increase of export sales over that of the previous year.

The Hon'ble the Minister of Trade and Industry will be moving an appropriate Amendment Bill to the Investment Incentive Act in this House during the current session for debate and approval so that the proposed revision to export incentives could be implemented.

### Export refinancing facilities

Hon'ble Members will recall that as a part of the Government's policy to promote manufactured exports, Bank Negara has been providing the export trade with concessional post-shipment as well as pre-shipment refinancing facilities. We have reviewed these facilities and I now propose to further expand pre-shipment facility, to include rubber and plastic products, footwear, metal products, sports goods and furniture. With the proposed expansion, the coverage will now be increased to about 25 percent of the total manufactured exports.

The battle against inflation cannot be the responsibility of the Government alone. The private sector must also play its part. Among others, I have often alluded to the need for a strong and well organised consumer movement. Businessmen and manufacturers also have a role. In particular, they owe it to their customers to purchase always from the cheapest markets. Since the onset of the Third Malaysia Plan, the ringgit has appreciated against the US dollar by more than 20 percent, against sterling by over 10 percent and in 1979, against the Japanese yen by 18 percent. Importers and manufacturers must take advantage of our inherent strength and react promptly to diversify their sources of supply to the cheapest sources, to alleviate the impact of imported inflation on the domestic price level.

On the whole, we have done well in expanding the nation's manufactured exports, which are directed mainly at the more traditional markets in the major industrial nations. While we need to nurture these markets, greater efforts must be made to develop the growing dynamic markets nearer home through regional cooperation.

The East-Asian countries and ASEAN have great potential for trade and industrial expansion. Furthermore, there are a vast potential and prospects for trade and industrial cooperation within the great Pacific Basin. This vast and rich region provides tremendous opportunities for the future. Indeed, while we are on the threshold of the 1980s, Malaysia must begin to think hard about planning for the promising possibilities and potential for trade and industry within the context of the larger Pacific Basin. We must look further ahead. We must raise our sights.

We cannot continue to look to the industrial countries so-called, The North. Time and again the developing countries have been turned down in their legitimate case for the establishment of a New International Economic Order.

As agreed by the developing countries at the last Unctad V Meeting, we must do much more to increase trade and industrial cooperation amongst developing countries themselves. Besides the great potential that there is in ASEAN and other Asian developing countries, we can and should also look forward with confidence to expanding our trade relations with *Islamic* countries, with whom we have increasingly strong fraternal relations.

**Establishment of a warehousing system in Malaysia**

As Hon'ble Members are aware, warehousing facilities are currently very limited. It is felt that the facilities should be expanded as it will lead to better Customs supervision and more competitive prices as the importers will be able to import "bulk". Thus, it is proposed that more licences to establish warehouses will be issued throughout the country. The private sector is expected to play a major role in owing and operating these warehouses. It is also proposed that spare parts, fruits and canned food, cosmetics, watches and chemicals be included as items which may benefit from the bonded warehouse facilities. The list of items may be extended from time to time.

The operation of a warehouse requires a licence from Customs Department to whom applications could be made.

**Proposal to reduce tax burden on public transport sector - taxis, hire-cars and buses**

In order to improve the public transport service to the people it is felt that some incentives should be given. Towards this objective, I propose to:

(a) Reduce the excise duty on taxis and hire-cars by 50 percent.
(b) Reduce the road tax on taxis and hire cars by 50 percent.
(c) Reduce the engine tax on buses by 25 percent.

**Proposal to increase road tax on privately owned diesel cars**

As Hon'ble Members are aware, the subsidy on diesel is aimed to benefit the industrial users as well as the public transport industry so as to restrain price increases and was never intended to benefit owners of private diesel cars. Therefore, I propose that the road tax on privately owned diesel cars be increased to five times that of the road tax on cars using petrol compared to the present rate of four times.

**Import duty and excise**

Hon'ble Members will observe that the 1980 Budget has not given much attention to the reduction of import duties. This is not because the Government does not wish to reduce import duties, particularly for the goods consumed by the lower income groups. On the contrary, I can assure you that the Government has been reducing or eliminating import duties, on essential food items as well as other items of mass consumption. Whatever dutiable items there are, it is largely to protect our own domestic industries against competition and could not be reduced at the moment.

For this year's Budget therefore, I have little to offer except to propose duty reductions on a very restricted number of items as follows:

(a) Import duties on durians, mangoes and jackfruits are reduced by another 50 percent,
(b) import duty on film/negatives for movie industry is reduced from 40 to 50 percent,
(c) import duties on some sports goods such as racing bicycles, sports gloves and appliances for gymnastics are removed,
(d) import duty on cylinder block is reduced from 75 to 25 percent.

I also propose to remove the excise duty on reconditioned batteries so that the treatment is the same as for retreaded tyres. Excise duty on foam rubber mattress is also reduced from 44 sen per kg. to 33 sen per kg., so as to be on par with the duty on artificial foam plastic mattresses.

**Tax incentives to encourage investment and restructuring**

As Hon'ble Members are aware the Government is taking the lead to promote overall economic growth and investment in particular. However, the private sector has to support and supplement the Government's investment initiatives more strongly, in order to sustain and strengthen the growing importance of the private sector's role in promoting balanced economic growth and investment under the New Economic Policy. We therefore need to ensure that the NEP goals for restructuring are achieved on schedule. This requires concerted effort on a sustained basis through all aspects of Government policies which include fiscal policy. I therefore propose the following tax measures as incentives to accelerate the pace for restructuring and the promotion of investments and economic growth:

(a) Currently all companies have to pay income tax at a rate of 40 percent. Under the proposal, companies with a paid up capital of not less than $ 1 million or with a net asset of not less than $ 1 million which conform to the equity restructuring requirement of the Government, will only pay income tax at a lower rate of 35 percent.
(b) I am also proposing that companies which conform to restructuring with respect to employment and/or marketing network be exempted from Development Tax of 5 percent.

Both these exemptions are to be accorded upon the production of annual certification by the Foreign Investment Committee (F.I.C.). These incentives are to be offered for only 3 assessment years from assessment year 1980 to assessment year 1982.

Hon'ble Members are aware that the Government is determined to set up the pace of corporate restructuring, not only through fiscal incentives but in participating directly in the commercial and industrial sector of the economy.

The promotion of a more rapid rate of growth in private investment, in conjunction with the attainment of our national restructuring objective, will ensure not only balanced, but also stable and steady industrial growth and expansion. Thus, the 1980 Budget provides $ 1,086 million to promote and strengthen the Government's industrialisation policy. Of this large amount, a sum of $ 227 million will be provided to State Economic Development Corporations to promote industrial development in conjuction with the private sector. The Government's industrial participation in joint-enterprises with the private sector, will help to achieve our socio-economic objectives, in a mutually reinforcing manner, since both the public and the private sectors will stand to gain much from mutual cooperation to achieve our common objectives.

As a further measure to accelerate the progress that has so far been achieved in increasing the equity ownership of the Bumiputra community, an additional sum of $ 300 million is provided to supplement the present capital of $ 200 million in the Bumiputra Investment Fund.

We recognise that one of the major constraints to the expansion of Bumiputra ownership and participation in the corporate sector is the lack of finance. Therefore the 1980 Budget provides $ 256 million to supplement the credit resources and facilities of Government's major institutions, that have been established to achieve the objectives of restructuring i.e. Pernas, UDA and MARA.

I might add that these additional resources will help supplement the new guidelines on bank lending which were introduced two months ago for commercial banks and finance companies.

It is clear therefore that the Government is doing its best, in cooperation with the banking sector, to provide increasing amounts of loanable funds to the Bumiputra community and small scale enterprises, and agricultural food production to accelerate private investment and our restructuring objectives.

In line with the New Economic Policy, the Government is now making preparations for the transfer of shares in successful Government-owned companies to Bumiputras. The transfer process will take time as it may involve amending some existing legislations. However, it is hoped that the transfer could be effected by mid-1981 through a scheme now being formulated, which will ensure that a majority of the shares in Government-owned companies will come under the control of a large segment of the lower-income population. The Bumiputra Investment Fund, operating under its own scheme, will be one of agencies for this purpose. In this way it is hoped that the lower-income groups will be able to enjoy the fruits of this *share transfer plan* as they will be able to control the biggest portion of the shares in successful Government companies.

As a preparatory measure to encourage small investors or low-income individuals to save and invest their money in profitable schemes, I propose that the profits of approved unit trusts will be exempted from income tax and that dividends not exceeding $ 4,000 a year received by the taxpayer, who is a unit holder, will also be exempted from income tax.

**Malaysia's Economic and Budget Forecast for 1980**

I have outlined the 1980 Budget Strategy and presented my proposals to achieve the Budget's Strategic Goals. The question that now remains is: *What then are Malaysia's economic and budgetary prospects for 1980?*

Hon'ble Members will agree that it is extremely diffcult to be precise about economic and financial estimates for the future, particularly when there is so much international economic uncertainty and monetary instability.

Be that as it may, current indicators point to a real growth in the domestic economy of about 6-7 percent for 1980 as a whole. Implementation of the Budget Strategy I have outlined would provide a firm foundation for the economy to grow faster than envisaged, not just in 1980 but also in the immediate years beyond. Both the tax cuts of $ 482 million and the tax concessions as well as subsidies relating to electricity and petroleum products amounting to $ 491 million in 1980, will have the effect of achieving the Budget objectives. With these firmly in place, we can reasonably expect the domestic price level to stabilise at about 5-6 percent in 1980.

The big tax cuts have been possible not only because of the basic resilience of our economy, but also because of the consistently strong Budget performance and the favourable outturn estimated for next year. The 1980 Budget's Current Account surplus is estimated at $ 515 million before tax changes and $ 33 million after tax changes.

These big tax cuts together with large Expenditures and subsidies have enabled us to design the Budget Strategy of promoting Economic Growth and Combatting Inflation, to not only encourage further investment and expand production but also to help, particularly the poverty and lower income groups, to face the economic difficulties that lie ahead.

## SOME MAJOR PROPOSED TAX AMENDMENTS

### A. INDIVIDUAL INCOME TAX

Under the existing tax structure, the tax burden for various chargeable income, after allowing all possible deductions is as follows:

| Chargeable income ($) (1) | Marginal rate (%) (2) | Marginal liability ($) (3) | Liability ($) (4) | Average tax rate (%) (5) |
|---|---|---|---|---|
| 1,000 – 2,500 | 6 | 150 | 150 | 6.0 |
| 2,501 – 5,000 | 9 | 225 | 375 | 7.0 |
| 5,001 – 7,500 | 12 | 300 | 675 | 9.0 |
| 7,501 – 10,000 | 15 | 375 | 1,050 | 10.5 |
| 10,001 – 15,000 | 20 | 1,000 | 2,050 | 13.7 |
| 15,001 – 20,000 | 25 | 1,250 | 3,300 | 16.5 |
| 20,001 – 25,000 | 30 | 1,500 | 4,300 | 19.2 |
| 25,001 – 35,000 | 35 | 3,350 | 8,300 | 23.7 |
| 35,001 – 50,000 | 40 | 6,000 | 14,300 | 23.6 |
| 50,001 – 75,000 | 50 | 12,500 | 26,800 | 35.2 |
| 75,001 and above | 55 | – | – | – |

The tax burden on chargeable income is shown in column (5).

It is proposed that the following measures be taken in respect of the individual income tax structure:

**(a) Relief for individual**

At present the reliefs for the individual are in the form of:
(i) personal relief of $ 2,000
(ii) earned income of 1/10 of income or $ 1,000 whichever is lower;
(iii) rebate of $ 60. This is to be deducted from tax payable.

It is proposed that for 1980, the individual relief be replaced by a single individual relief of $ 5,000 and relief on earned income be withdrawn. Out of the $ 3,000 increase, the first $ 1,000 is an actual increase of individual relief, while the second $ 1,000 is to provide relief for dependents and the final $ 1,000 is to convert earned income relief into an additional individual relief. The present rebate of $ 60 is to be retained.

**(b) Wife's relief**

At present the reliefs for wife are as follows:
(i) wife's relief of $ 1,000;
(ii) wife's earned income of 9/10 of income of maximum of $ 500; in case where earned income exceed $ 5,000 1/10 of income or maximum of $ 1,000.
(iii) a rebate of $ 30. This is to be deducted from tax payable.

It is proposed that the relief for wife be increased to $ 2,000 and that the relief for wife's earned income be withdrawn. The rebate for wife of $ 30 is to be continued.

**(c) Allowance for children educated abroad**

The current allowance for children educated abroad is double the amount of children's relief.
It is proposed that the allowance for children educated abroad be *four times* the normal deductions which currently are as follows:

| | |
|---|---|
| 1st child | $ 800 |
| 2nd child | $ 700 |
| 3rd child | $ 600 |
| 4th child | $ 500 |
| 5th child | $ 400 |

**(d) Revision of top chargeable bracket**

Currently chargeable income exceeding $ 50,000 but not exceeding $ 75,000 is taxed at a rate of 50 percent while income exceeding $ 75,000 is subject to a rate of 55 percent. With the objective of providing more incentive for work effort, it is proposed to reduce the tax liability on chargeable income exceeding $ 50,000. Under the proposal, chargeable income exceeding $ 50,000 but not exceeding $ 75,000 will be subject to a reduced rate of 45 percent and for income exceeding $ 75,000 but not exceeding $ 100,000, the rate will be 50 percent. For income exceeding $ 100,000 the rate will be 55 percent. For excess profit tax, the present exemption limit of $ 75,000 for any person (other than a company) is raised to $ 100,000. Therefore, an individual will be liable to excess profit tax only on chargeable income which exceeds $ 100,000.

The table below gives a comparison of tax liability under the present and proposed reliefs for individual and wife at various income levels:

| Income | Tax payable ($) Present | Proposed | Tax saving to taxpayer |
|---|---|---|---|
| 5,000 | nil | nil | nil |
| 10,000 | 345 | 120 | 225 |
| 20,000 | 2,085 | 1,560 | 525 |
| 30,000 | 4,885 | 4,110 | 775 |
| 50,000 | 12,410 | 11,410 | 1,000 |
| 75,000 | 24,550 | 22,400 | 2,150 |
| 100,000 | 39,010 | 35,710 | 3,300 |

The above proposal is to take effect from assessment year 1980.

## B. EXTENSION OF PREVIOUS BUDGET MEASURES

### (i) Accelerated depreciation allowance

The *accelerated depreciation allowance* comprising of an initial allowance of 20 percent and an annual allowance of 80 percent for capital expenditure on plant and machinery was introduced in the 1977 Budget for the agro-based and related industries for a period of 3 years from assessment years 1978 to 1980. The scope of accelerated depreciation allowance was extended in the 1973 Budget to all industries undertaking capital expenditure for assessment years 1979 and 1980. It is proposed that the period of offer be extended by 3 more years up to and including assessment year 1983.

### (ii) Reinvestment allowance

In the 1979 Budget, a *reinvestment allowance* of 25 percent of capital expenditure on plant machinery and on industrial building (deductible from adjusted income) was offered for a period of three years from assessment years 1980 to 1982 (basis years 1979 to 1981) to manufacturing and processing industries undertaking expansion as approved by the Ministry of Trade and Industry. To be in line with the extension of the accelerated depreciation allowance to assessment year 1983, it is proposed that the period for reinvestment allowance should also be extended by another year up to and including assessment year 1983.

## C. TAX INCENTIVE FOR INWARD REINSURANCE

Income from inward reinsurance business is assessable to income tax at 40 percent, development tax at 5 percent and excess profit tax at 5 percent on the chargeable income which exceeds the appropriate franking limit.

It is proposed that preferential tax treatment be accorded to inward reinsurance business in order to encourage the flow of profitable reinsurance business to Malaysia from other countries. It is proposed that the present 40 percent rate applicable on profits from inward reinsurance business be reduced to 5 percent. The proposal will be made effective for assessment year 1980 and subsequent years of assessment.

## D. TAX INCENTIVE FOR REAFFORESTATION

It is proposed that the growing of timber be encouraged by extending to reafforestation the tax treatment which presently applies to the planting industry. Cultivated timber will be brought within the definition of "approved crops" in the Income Tax Act to enable reafforestation to qualify for capital expenditure incurred on clearing of land, new planting and construction of roads to be written off over 2 years. Capital expenditure on labour lines will be allowed to be written off over 5 years and capital expenditure on other buildings allowed to be written off over 10 years. In addition, any expenditure incurred on replanting will be allowed to be deducted against the revenue of the year in which such expenditure is incurred. Further, rules will be introduced under the Income Tax Act to enable plant and machinery used in reafforestation to qualify for an increased initial allowance of 60 percent compared to the normal rate of 20 percent.

## E. TAX INCENTIVES FOR EXPORTS

At present export incentives are given under the Investment Incentives Act, 1967, and these are:

### (i) Deduction for promotion of export

These are given in respect of expenses incurred for promotion of exports of manufactured products. Export expenses that qualify for deductions are:

(a) advertising expenses
(b) provision of free samples
(c) market research
(d) preparation of tenders
(e) overseas travel for negotiations and contracts
(f) expenses for giving technical information to buyers.

The deductions allowable are given in addition to any deductions allowable under Section 33 of the Income Tax Act 1967.

### (ii) Accelerated depreciation allowance

Under this incentive about 90 percent of the initial outlay or capital could be written off in 5 years, instead of the 20 or more years at normal rates of depreciation allowance.

### (iii) Export allowance

An allowance at the rate of 5 percent of the increase in export over the average exports of the preceding five assessment years is given as deduction from gross income. The rate is increased to 8 percent in the case of companies which use not less than 50 percent of local material in their export products.

It is proposed that the export incentives be given by:

(a) allowing additional deduction for the cost of maintaining sale offices overseas for promotion of export;
(b) replacing the present export allowance with an outright export allowance of 2 percent of ex-factory value of export sales and an additional 10 percent of ex-factory value of export sales on the increase of export sales over the export sales of the previous year. It is proposed that this allowance be given on all export sales irrespective of local content.

Crude olein and stearin, neutralised olein and stearin, neutralised palm oil, and neutralised bleached palm oil, tapioca chips, fresh fruits and vegetables, cocoa beans, coffee beans, sand, clay and stones (including granite and limestone), livestocks, and products of industries engaged in the manufacture or assembly of electrical and electronic components are to be included in the list of products not eligible for export allowance.
The proposal is to take effect from assessment year 1980.

## F. TAX INCENTIVE FOR RESTRUCTURING

It is proposed that the following tax measures be adopted as incentives for restructuring:

### (a) Equity restructuring

Exemption of 5 percentage points of the company income tax

of 40 percent is to be allowed to any company conforming to the equity restructuring requirement of the NEP with at least 30 percent equity ownership for Bumiputras, 40 percent for non-Bumiputra Malaysians and 30 percent for foreigners.
In order to expedite the achievement of the target, the above incentive is initially suggested to be offered on a yearly basis for 3 assessment years from assessment year 1980 to assessment year 1982. The attraction of this proposal is that it encourages companies to restructure early in order to reap the benefit of the tax reduction. In order to qualify for exemption, the company must either have a paid-up capital of $ 1 million unimpaired by contingent liabilities or have a net asset (before revaluation) of not less than $ 1 million. Pioneer companies and companies enjoying tax incentives will not qualify for this incentive.

**(b) Employment and/or marketing network restructuring**

Any company conforming to the employment and/or marketing network restructuring will be exempted from the development tax of 5 percent.
The period of offer is similar to (a) above i.e. on a yearly basis for three assessment years from assessment year 1980 to assessment year 1982.

Both exemptions above are to be accorded on annual certification by the Foreign Investment Committee (FIC). FIC will issue the certificate after consultation with the relevant authorities.

## G. TIN PROFITS TAX

In view of the proposed restructuring of export duty on tin which will benefit the profitable mines more, it is now proposed to raise the present maximum rate of tin profits tax from 12½ percent to 15 percent as follows:

| Taxable tin profits (after providing for exemptions) | Rate Present (%) | Rate Proposed (%) |
|---|---|---|
| First $ 200,000 | 5 | 5 |
| next $ 200,000 | 10 | 10 |
| exceeding $ 400,000 | 12½ | 15 |

The proposal is to be made effective from assessment year 1980.

## H. TAX EXEMPTIONS FOR APPROVED UNIT TRUSTS AND MALAYSIAN UNIT-HOLDERS

The incentive proposed is to exempt unit trusts which are approved by the Minister of Finance. Also resident unit holders who are taxpayers are exempted from the individual income tax in respect of the dividends they receive subject to a maximum amount of $ 4,000 per year which works out to a return of 8 percent on an investment of $ 50,000 in unit trusts.
The proposal is to take effect as from assessment year 1980.

## I. REVIEW OF ESTATE DUTY

Three policy changes proposed are:

(a) The present exemption level for the estate of deceased person who died domiciled in Malaysia which presently is at $ 50,000 is proposed to be raised to $ 300,000. Only values of estates in excess of $ 300,000 will now suffer estate duty. The exemption level for the estates of a non-domiciled deceased which presently is at $ 10,000 is proposed to be revised to $ 60,000.

(b) It is also proposed that the present 50 percent abatement against estate duty be abolished.

(c) The estate duty structure for estates of domiciled deceased is to be revised as in the attached table. Under the proposed structure, the estate duty liability will be lower as compared with the existing structure for an estate not exceeding $ 700,000 in value. For an estate with value exceeding $ 700,000 the liability will be higher under the proposed than under the present structure.

(d) Funeral expenses are now proposed to be raised to $ 3,000 from the present $ 1,000 or 2½ percent of ascertained value of estate, whichever is lower.

(e) Any money received under a personal accident insurance policy will not be subject to estate duty.

The amendment will apply to the estate of any person dying on or after 18th October 1979.
The above proposals are applicable to Peninsular Malaysia, pending extension of the law to Sabah and Sarawak.

### ESTATE DUTY

| Taxable income | | Proposal: Rates (%) (1) | Proposal: Amount payable (2) | Proposal: Effective rate (%) (3) | Existing: Amount payable after 50% abatement (4) | Existing: Effective rate (%) (5) |
|---|---|---|---|---|---|---|
| On First | 300,000 | | nil | | $15,000 | 5 |
| next | 100,000 | 12 | 12,000 | | | |
| first | 400,000 | | 12,000 | 3 | 25,000 | 6.2 |
| next | 100,000 | 16 | 16,000 | | | |
| first | 500,000 | | 28,000 | 5.6 | 50,000 | 8.3 |
| next | 200,000 | 20 | 40,000 | | | |
| first | 700,000 | | 68,000 | 9.7 | 65,000 | 9.3 |
| next | 300,000 | 25 | 75,000 | | | |
| first | 1,000,000 | | 143,000 | 14.2 | 115,000 | 11.5 |
| next | 500,000 | 30 | 150,000 | | | |
| first | 1,500,000 | | 293,000 | 19.5 | 215.000 | 14.3 |
| next | 500,000 | 35 | 175,000 | | | |
| first | 2,000,000 | | 468,000 | 23.4 | 327,500 | 16.4 |
| next | 1,000,000 | 40 | 400,000 | | | |
| first | 3,000,000 | | 868,000 | 28.9 | 577,500 | 19.3 |
| next | 1,000,000 | 45 | 450,000 | | | |
| first | 4,000,000 | | 1,318,000 | 32.9 | 827,500 | 20.7 |
| next | 1,000,000 | 50 | 500,000 | | | |
| first | 5,000,000 | | 1,818,000 | 36.4 | 1,102,500 | 22.0 |
| next | 1,000,000 | 55 | 550,000 | | | |
| first | 6,000,000 | | 2,368,000 | 39.5 | 1,377,500 | 22.9 |
| on remainder | | 60 | | | | |

# MALAYSIA: Deductibility of Foreign Losses – Two Bites at the Cherry –

**Hock Heng Co. S'dn. Bhd. v. Director-General of Inland Revenue**

by C.S. Yeoh *

*Malaysian Income Tax – Malaysian resident company with Singapore branch – whether company can set off Singapore branch's loss against Malaysian income – Income Tax Act, 1967 (Malaysia) – Malaysia/Singapore Double Taxation Agreement 1966.*

Three main factors affect any claim for loss relief by an enterprise if such losses arise from activities in a foreign territory. These factors are-
(i) the local law,
(ii) double taxation treaties, if relevant, and
(iii) case law.

In *Hock Heng Co. Sdn. Bhd. (private limited) v. Director-General of Inland Revenue*, the taxpayer, a Malaysian company, which was ordinarily resident in Malaysia, had its head office in Malaysia and a branch in Singapore. For the year of assessment 1968, the head office made a profit of M$ 31,415 whilst the branch incurred a loss of M$ 538,335.

Under Section 3(a) of the Income Tax Act, 1967 (hereinafter referred to as "the Act") the global income of a Malaysian company was subject to Malaysian income tax. This section as applicable to the year of assessment 1968 reads :

> "... income tax shall be charged ...
> (a) in the case of a person ordinarily resident ... upon his income from wherever derived; ..."

By virtue of Paragraph 1(a), Article IV of the Double Taxation Relief (Republic of Singapore) Order, 1966 (hereinafter called "the Agreement" or "treaty"), profits of a permanent establishment in Singapore of a Malaysian enterprise were exempt from Malaysian tax. The relevant paragraphs of this Article are reproduced below:

> "1. (a) The profits of a Malaysian enterprise shall not be taxable in Singapore unless the enterprise carries on business in Singapore through a permanent establishment situated in Singapore. If the enterprose carries on business as aforesaid, tax may be imposed in Singapore on the profits of the enterprise but only on so much of them as is attributable to that permanent establishment. No further tax shall be imposed in Malaysia in respect of profits of the permanent establishment which are remitted to Malaysia. ...
>
> 2. Where an enterprise of one of the Contracting States carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing independently with the enterprise of which it is a permanent establishment.
>
> 3. In determining the profits of a permanent establishment, there shall be allowed as deduction all expenses, including executive and general administrative expenses, which would be deductible if the permanent establishment were an independent enterprise in so far as they are reasonably allocable to the permanent establishment, whether incurred in the Contracting State in which the permanent establishment is situated or elsewhere."

The Agreement was silent as regards losses of a permanent establishment and Paragraph 1 of Article XVII of the treaty confirmed that unless otherwise provided in the treaty, the laws of Malaysia should continue to govern the taxation of income in that country. Paragraphs 1 and 2 of Article XVII are set out below:

> "1. The laws of each Contracting State shall continue to govern the taxation of income in that State except where express provision to the contrary is made in this Agreement. Where income is subject to tax in both Contracting States, relief from double taxation shall be given in accordance with the following paragraphs of this Article.
>
> 2. Where a resident of one Contracting State derives income from sources within the other Contracting State and that income in accordance with the income tax laws of each Contracting State and the provisions of this Agreement is subject to tax in the other Contracting State, the former Contracting State shall exempt such income from tax."

In computing the taxpayer's income for Malaysian tax purposes the Inland Revenue refused to allow a claim to have the Singapore loss be set off against the Malaysian income.

The taxpayer appealed to the Special Commissioners of Income Tax who decided in its favour. At the request of the Revenue a case stated was presented to the High Court.

At the High Court the learned Judge reversed the decision of the Special Commissioners. He based his judgement on the reasons given by him in the *United National Finance Bhd. v. Director-General of Inland Revenue* case of 1975. In disallowing a similar set-off of Singapore losses against Malaysian income in that case the learned Judge reasoned that such losses, if allowed, would have been deducted twice, once in Singapore and again in Malaysia.

The taxpayer then appealed to the Federal Court. The arguments put forward on behalf of the taxpayer may be briefly summarised as follows:

(a) At the relevant time under Section 3(a) of the Act, tax was payable on its income from wherever derived, i.e. upon world income. In computing its world income, losses suffered in Singapore should be deducted from profits in Malaysia - else, how could its world income be determined?

(b) In accordance with Section 44(2) of the Act, losses may be deducted and these must include, it was submitted, losses suffered in Singapore.

(c) Certain deductions were not allowed; these were enumerated in Section 39 of the Act. Losses suffered in Singapore were not included; therefore, such losses could be set against Malaysian profit.

(d) According to the ordinary principles of commercial accounting, all gains and losses must be brought into account when computing income.

(e) The Agreement and its enabling authority, Section 132 of the Act, provide for relief against double taxation; such relief was only in respect of profits made and taxed in Singapore. As the taxpayer had not claimed any relief against double taxation, the Agreement was not applicable and the losses should be allowed under Section 44(2).

The Court, however, found in favour of the Director General of Inland Revenue on the following grounds:

(i) Singapore losses, if allowed against Malaysian income, would have been doubly deducted. As Lee Hun Hoe CJ (Borneo) put it, "They cannot have two bites at the cherry".

(ii) Article IV (2) and (3) of the Agreement — business profits — provides that the Singapore branch and Malaysian head office were to be regarded as separate and distinct. In other words, the world income scope of Malaysian taxation had been transformed to the derivative scope and the Singapore losses could not be attributed to activities in Malaysia. Singapore losses should be deducted from Singapore profits and Malaysian losses from Malaysian profits.

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(iii) Section 3(a) of the Act has been overridden by the Agreement insofar as Singapore losses were concerned in that the branch and head office were to be regarded as distinct and separate.

An appeal by the taxpayer to the Privy Council followed. It was common ground that but for the said tax treaty, the appellant would have been entitled to set off the Singapore losses against its Malaysian income. The Privy Council was therefore faced with the question as to whether or not there were provisions in the Agreement which modify the 1967 Act insofar as the Singapore losses were concerned.

Viscount Dilhorne in his delivery of the Majority Judgement referred to Articles IV and XVII of the Agreement. In connection with the former Article he noted that any profits of a permanent establishment in Singapore of a Malaysian enterprise were taxable only in Singapore whether or not such profits are remitted to Malaysia. To this extent therefore the tax treaty qualified and modified the Act under which Malaysian tax was chargeable on all income wherever derived.

His Lordship added that expenses, as one would expect, are deductible in computing profits. Article IV was concerned with profits and what would happen to them. It did not purport to provide the tax consequences if losses were incurred.

With reference to Article XVII — Elimination from double taxation — their Lordships pointed out that paragraph (2) thereof was not applicable to the case because that paragraph referred to income only as opposed to losses. Paragraph (1), which provided that the laws of Malaysia should continue to govern the taxation of income in that state except where express provision to the contrary was found in the Agreement, was, in the opinion of their Lordships, determinative of the appeal. There were no express provisions regarding losses; hence the Act applied.

In their Lordships' view the *United National Finance Bhd.* case referred to earlier was incorrectly decided. They had sympathy for the concept that if profits from the Singapore branch were not taxable in Malaysia then, conversely, Singapore losses should not be allowed to reduce Malaysian income, but they said that the Agreement did not so provide. Lord Russel of Killowen chose to part company with the rest of the Board on this point. In his opinion an exemption from tax necessarily involved an exclusion from loss relief.

It was therefore held by a majority, Lord Russel of Killowen dissenting, that the appeal should be allowed and the Deciding Order of the Special Commissioners restored. The M$ 538,335 loss incurred by the Singapore branch could therefore be set against Malaysian income when ascertaining the company's income for Malaysian tax purposes for the year of assessment 1968.

**CONCLUSION:**

(1) The 1966 Order was made when the Income Tax Ordinance, 1947 was operative in Malaysia. Under this Ordinance tax was exigible on income accruing in or derived from the States of Malaya or received in the States of Malaya from outside territory.

(2) An immediate consequential amendment to the 1966 Order did not follow the replacement of the Ordinance by the 1967 Act which introduced the global scope of taxation.

(3) The said Order of 1966 has since been replaced by the Double Taxation Relief (Singapore) Order 1968 which had effect from the year of assessment 1969. Under this latest Order, Singapore profits attributable to a permanent establishment of a Malaysian enterprise in Singapore are no longer exempt from Malaysian tax.

(4) The scope of Malaysian income tax was altered as from the year of assessment 1974. There has been a reversion to the scope of the 1947 Ordinance and in its amended form Section 3(a) states:
"... income tax shall be charged ... upon income of any person accruing in or derived from Malaysia or received in Malaysia from outside Malaysia."
A loss cannot of course be remitted, so that under current law losses incurred through a Singapore branch are no longer deductible.

**EDITOR'S NOTE**

*Double deduction of losses — two bites at the cherry — by a taxpayer incurring a foreign loss will occur where there exist provisions (usually a tax treaty) which exempt foreign-source income from domestic income tax. In those cases where double taxation is prevented by allowing a credit for foreign tax against domestic income tax the problem will not arise. However, where the exemption-method is used the question immediately arises whether disregarding foreign income necessarily means that foreign losses must also be disregarded. Should this be allowed then the losses may usually be deducted twice, i.e. first in the country where the taxpayer is resident and later — when there is foreign-source income — in the country where the loss was incurred. Some countries like the German Federal Republic and Luxembourg, therefore, disregard foreign losses. Other countries, like Belgium and the Netherlands introduce a special clause in their tax treaties under which foreign losses are recaptured.*

# CONFERENCE DIARY

## APRIL 1980

*Management Centre Europe:* International Tax Conference (including Possibilities and limitations of treaty shopping; Tax problems arising from the entrance of East European Countries and China into the international investment field), Montreux (Switzerland) April 14-16 (English, French, German).

*Business International Institute:* The Seminar on International Finance (including: Taxation of exchange gains and losses), White Plains, New York (U.S.A.) April 14-17 (English).

*Seminars International:* International Finance Conference ("Multi-choice") (including Taxation of foreign currency gains and losses), London (United Kingdom) April 16-18 (English).

*Seminar Services International:* 12th International Tax Planning Symposium (Part I: two introductory courses; Part II: mulichoice programme with 4 separate seminars running simultaneously), London (United Kingdom) April 23-25 (English).

## MAY 1980

*Anglo-US branches:* Seminar (subjects not yet known), New York (U.S.A.) May 8 and 9 (English).

*U.S. branch of I.F.A.:* Technical Session (subject not yet known), New York (U.S.A.) May 10 (English).

*International Association of Assessing Officers:* Fifth International Symposium on the Property Tax, Amsterdam (The Netherlands) May 7-10, Paris (France) May 11-15 (English).

*International Tax Planning Association:* The Cannes Tax Conference (including exchange of information under tax treaties), Cannes (France), May 28-30 (English).

## JUNE 1980

*Business International Institute:* The Seminar on International Finance (including: Taxation of exchange gains and losses), Port Chester, New York (U.S.A.) June 9-12 (English).

## JULY 1980

*Management Centre Europe:* The China Briefing (including: Tax aspects of doing business in China), Brussels (Belgium) July 3-4 (English).

## SEPTEMBER 1980

*34th Annual Congress of I.F.A.:* I. The dialogue between the tax administration and taxpayer up to the filing of the tax return; II. The determination of the source of income. For the seminar the subject is the flight to tax havens, their use and abuse. Paris (France), September 14-19 (English, French, German, Spanish).

## NOVEMBER 1980

*Confédération Fiscale Européenne (C.F.E.):* Second Congress of European Tax Consultants (subject: "La pratique de la Fiscalité en Europe"), Rome (Italy), November 6-8 (English, French, German).

FOR FURTHER INFORMATION PLEASE WRITE TO:

Business International Institute, 12-14 chemin Rieu, 1211 Geneva 17 (Switzerland).

Confédération Fiscale Européenne, Secrétariat Général (C.F.E.), D-5300 Bonn 1, Dechenstrasse 14, German Federal Republic or Siège Social F-75008 Paris, 9 rue Richepanse, France.

Investment and Property Studies Ltd., Norwich House, Norwich Street, London EC4A 1AB, United Kingdom (Registration for the Cannes Tax Conference should apply to this address);

International Association of Assessing Officers, 60th Street, 60637 Chicago 1313 East, U.S.A.

International Fiscal Association (I.F.A.): General Secretariat, Woudenstein, Burgemeester Oudlaan 50, P.O. Box 1738, 300 DR Rotterdam (Netherlands).

Management Centre Europe, Avenue des Arts 4, B-1040 Brussels (Belgium).

Seminars International, 93 Chancery Lane, London WC2A 1DT, United Kingdom.

Seminar Services International see Seminars International.

# TAX GLOSSARY

*by H.W.T. PEPPER**

**PROGRESSION** — See GRADUATION.

**PROGRESSIV SKAT** — (Denmark) Progressive tax.

**PROOF SPIRIT** — "Proof" is a concept adopted in the U.K. in connection with the levy of customs and excise duties on spirits (i.e., drinks such as brandy, gin, whisky, containing distilled alcohol). Proof spirit contains 57.06 parts of alcohol by volume in each 100 parts of spirit at a temperature of 51°F.

**PROPERTY APPRECIATION TAX** — A form of CAPITAL GAINS TAX (q.v.) operated by municipalities in Italy. The tax is at graduated rates imposed between upper and lower limits set by the central government, and is of interest because it contains a simple form of "index" adjustment to "write up" the original cost of the property, by a percentage for each year it has been held, when computing the capital gain.

**PROPERTY TAX** — This term, which was originally applied to the income tax introduced (in 1798) by Pitt in Britain, is more usually applied to local taxes on real property, although there are examples of the term being applied to a wealth tax (on the total "property" of the taxpayer in Guyana). As a levy on real property, property tax may be charged on unimproved land values, but the term is more usually applied to a tax on land plus improvements generally levied by a local authority as a means of obtaining revenue to meet local expenditure, which may be of benefit to the owners and occupiers of property in the local administrative area.

**PROPORTIONAL SKAT** — (Denmark) Flat rate tax.

**PROPOSITION 13** — A proposal, referring to a referendum in the State of California, that property tax in that State on residential and commercial property should be levied at a rate not higher than 1 percent on capital, and that assessments should be based on 1975/76 appraised values, or the current value when purchased in the case of newly-built properties. The Californian law permits such proposals to be initiated by a minimum number of voters. Proposition 13 succeeded and resulted in a cut in property tax revenue to the State of approximately two-thirds, as well as evoking admiration and a desire to emulate among taxpayers in other States.

**PRO RATA RULE** — The credit due under the V.A.T. system used by E.E.C. members in respect of the trader's inputs may be restricted where some of his sales are taxable and some are not. It is logical to restrict the credit proportionately to the taxable sales and the use of the pro-rata rule is contained in Article II (2) and .22 of Annexe 'A' of the 2nd Directive to E.E.C. members.

**PROSPECTING** — See EXPLORATION EXPENDITURE.

**PROSPECTING, ABORTIVE** — See ABORTIVE PROSPECTING.

**PROSPECTORS AND GRUBSTAKERS** — The Canadian tax code makes special provision for prospectors and grubstakers who sell mineral properties they have acquired by successful exploration. Where the prospectors and grubstakers receive shares in a corporation in exchange for their interests they will not be taxed on the proceeds of such sales. The shares will, however, be deemed to have a nil cost if the question of capital gains tax later arises on their subsequent disposal, and the corporation acquiring the properties is deemed to have done so at nil cost.

**PROTECTIVE ASSESSMENT** — Where an assessment of a person's tax liability has not been made, because of delay in obtaining information, or in obtaining agreement as to basis, etc., and the time limit for making assessments is in danger of expiring, an estimated assessment may be made to protect the position of the Revenue department. Such assessments are also known as JEOPARDY ASSESSMENTS (q.v.).

**PROTECTIVE DUTIES** — See PROTECTIVE TARIFFS. The term "protective duty" in Britain was used to refer initially to the batch of duties which were introduced in 1932, which applied only to non-Commonwealth goods, and were chargeable at an ad valorem rate of 10 percent on all imports not held dutiable or not included in a free list. Additional protective duties above the 10 percent level could be imposed on the recommendation of the Import Duties Advisory Committee. The duties supplemented an initial instalment of protection which was conferred in respect of a few products by the KEY INDUSTRY DUTIES (q.v.) of 1921.

**PROTECTIVE TARIFFS** — Protective tariffs may either erect a "tariff wall" of very high duties which effectively eliminate competition altogether from a home enterprise, which is either an INFANT INDUSTRY (q.v.) or which represents a traditional activity which is in danger of destruction by cheap competitive imports. Otherwise, protective tariffs may merely give partial protection so that although foreign imports are not excluded, the corresponding local industries are allowed a price "margin", equivalent to the amount of duty, which enables them to continue to supply part of the home market.

**PROVIDENT FUND** — The term generally refers to a fund to which both employer and employee contribute sums which are invested and accumulated to produce a retirement benefit for the employee in the form of a lump sum, representing moneys accumulated on his account plus the interest, dividends, etc. thereon. Such funds are usually approved for income tax purposes, subject to certain conditions, in countries where this form of provision is customary, so that contributions are tax-deductible. The final lump sum benefit may be exempted from tax, but if invested or converted to an annuity, the resulting income will be taxable. PENSION SCHEMES (q.v.) or FUNDS are the more usual type of retirement provision for employees by employers. (See also PURCHASED ANNUITY.)

**PUBLIC SECTOR BORROWING REQUIREMENT (PSBR)** — The total sum which a government budgets to borrow from the private sector during

* With the assistance of the staff of the International Bureau of Fiscal Documentation.

the fiscal year. PSBR determines tax policy to some extent, e.g., if it is desired to reduce PSBR this can only be done by reducing government spending or increasing taxation, or both.

**PUBLIC UTILITY TAX** — In some countries, public utilities are not subjected to taxation, particularly where run as state enterprises, on the basis that such taxation would be regressive on the poor and increase the cost to industry of the products or services supplied by the utility. In other countries, taxes are levied on the profits of public utilities, whether or not they are state owned. Under general sales tax codes, including V.A.T. systems, it is not uncommon to find tax, usually at modest rates, being applied to the services provided by these undertakings in order to have a wider revenue base. (See also POWER TAX, TAX BASE.)

**PURCHASED LIFE ANNUITY** — The purchase of an annuity for life produces an income for the annuitant higher than he could obtain by investing the purchase price at the going rate of interest, dividends, etc. Some of the income yield is attributable to a return of capital. It is usual in tax legislation to levy income tax only on the income element in the annuity, exempting the capital element.

**"PURCHASE FROM SALES" METHOD** — The method of computing V.A.T. by charging tax on the gross sales and then deducting the tax embodied in purchases and other inputs in order to determine the tax payable by the trader on the values added to the products or services he is selling.

**PURCHASE TAX** — The term used in the U.K. and a few other countries to refer to a wholesalers' or manufacturers' sales tax. The U.K. levied the tax basically on *sales* at the wholesale level so that in one sense the name was a misnomer, but it reflected the original purpose of the tax which was to discourage the purchase of scarce goods during World War II, as well as to raise revenue.

**PYRAMIDING** — See ESCALATION.

# Q

**QUASI SALES TAX** — Various minor levies on goods, e.g., PACKAGE TAX, CUSTOMS HANDLING CHARGE, INVOICE TAX, TRANSACTIONS TAX, STAMP DUTIES (q.v.) on documents, etc., particularly if related in any way to the value of goods, amount in substance to a tax on the goods, which inevitably will be reflected ultimately in the price.

**QUASI TAXATION** — Some government measures, although not regarded as taxation, place a financial burden on one section of the community usually to the short-term benefit of another section, by means of arbitrary and often illogical sorts of transfer payments.

For example, price control, when it reduces profit margins to the trader below the normal level for the trade, constitutes a levy upon him in favour of his customer, which still applies even when the trader is a small shopkeeper and the customer comparatively wealthy. The result may be to deter some traders from dealing in the controlled commodity, giving the customer more trouble and expense in obtaining it. Rent control may restrict rent on long-let property well below the current economic rent, which is a levy on the landlord in favour of the tenant, but the latter may be more affluent than the former. The result is to reduce the inclination of entrepreneurs to build houses to let, placing an even greater burden on the government itself to fill the need.

Some governments decree arbitrarily that employers should increase their employees' remuneration, or pay them bonuses, or refrain from discharging redundant employees when a business shrinks in size. All these measures represent a levy or "tax" on the employer in favour of the employee, which may, however, result ultimately in the closure of the business and the loss of jobs, and, in the short-term, a reluctance of employers to engage more staff even when needed, and a reluctance by entrepreneurs to set up new enterprises.

Sound fiscal policy is to eliminate all types of quasi-taxes so that ordinary market forces and competition can make for a healthier economy.

**QUICK SUCCESSION RELIEF** — A form of relief normally applied to ESTATE DUTY (q.v.) where the duty has been paid on the inheritance of the estate of A (deceased) by B and then further duty arises where B dies within a short period of A's death, leaving his estate to C. To avoid the full rigour of duties being paid twice within a few years on the same assets, quick succession relief would be applied on B's death. The relief tends to be very substantial where the second death occurs within a few months, but it tapers off, and usually disappears after, say, 5 years. The current tendency, e.g., under CAPITAL TRANSFER TAX (q.v.) in the U.K. is for bequests to a surviving spouse to be free of tax, which, however, applies when the estate passes to a member of the next generation.

**QUOTAS, IMPORT** — Import quotas are a method of restricting imports to protect home industries without levying customs duties of a protective nature, the protection afforded being mainly a quantitative limitation of imports. Although in general such devices are frowned upon by G.A.T.T., they are sometimes preferable in being less likely to lead to exceptional price increases by the protected industries because of the existence of at least a modicum of imports at competitive prices.

Recent trends, e.g., in the U.S.A., have been to use the euphemism "Orderly Marketing Arrangement" (OMA) to describe arrangements, falling short of actual fixed quotas, whereby the exporting country, whose goods are damaging the importing country's own industries, is constrained to agree a voluntary restriction of its exports.

**QUOTATION OF TAX IN PRICE** — Although it is often required under sales tax laws that the marked price of goods sold by manufacturers or wholesalers should clearly indicate the tax element (this is a normal requirement, e.g., of V.A.T. schemes), the requirement does not normally extend to sales by retailers to consumers though some traders make a point of indicating the tax separately. There is a considerable extra burden of work involved in marking the tax as well as the price on goods displayed for sale, and although it is desirable that retail prices should be clearly marked on goods there is no apparent virtue in requiring the tax to be shown as well. Where price control is imposed, the main requirement of the administration is to know the price at which goods are sold to the consumer and there is usually comparatively little additional difficulty in ascertaining wholesale prices and mark-ups. On the other hand, retail sales taxes which are calculated as a flat percentage on total sales are required to be separately calculated on the bill to the consumer in the state sales taxes operated in most states of the U.S.A. Since most retailers in the U.S. have cash registers, the task of calculating the tax is usually delegated to the machine, although there are some complications when the retail sales tax is levied at more than one rate, so that goods have to be classified when preparing the bill. One school of thought suggests that it is in any event preferable not to bring the tax element in the prices too prominently to the consumers' attention, since the virtue of indirect taxation compared with direct taxation (that it is borne unheedingly and, therefore less resentfully would thereby be lost. (See UNMERKLICHKEIT.)

**QUOTITE FORFAITAIRE D'IMPOT ETRANGER** — (Belgium) Fixed credit for foreign tax imposed on foreign dividends, interest, and royalties.

# R

**RATCHET EFFECT** — Where there is a change in the incidence of sales taxes and other indirect taxation such that there is a reduction of tax on some goods and services and an increase on others, there may be a tendency for traders selling the former category not to reduce prices (taking the tax reduction as an extra profit) while other traders increase prices to allow for the additional tax. The tendency described is known as the "ratchet effect", namely, as in the mechanical working of a ratchet, the price, where it moves, moves only in one direction. See, however, QUOTATION OF TAX IN PRICE.

**RATE OF TAX** — In systems of direct taxation it is usual for the rate of tax to be graduated or progressive (see GRADUATION) whereas with indirect taxes it is more usual for the rate of each particular commodity or service to be levied at a flat rate percent or as a specific charge per unit (see, however, D SCHEME as an example of an attempt to levy graduated indirect taxation on different parcels of the same commodity). An exception to the general rule of graduation for direct taxes is that flat rate tax may be levied on income under a SCHEDULAR TAXATION (q.v.) regime or on the income arising within a country which is acquired by non-residents. (See also STANDARD RATE.)

**RATE REBATES** — In the U.K. a system of rebates of rates (property tax) for those in the lower income groups was introduced in 1967, the maximum rebate being two thirds. Somewhat akin to these rebates were the fixed cash rebates from property tax granted in some States of the U.S.A. representing the additional sales tax on food items arising when sales tax which had formerly been levied at a lower (or nil) rate on food was raised to the same level as sales tax on other goods for administrative simplicity. The rebates were related to the extra cost to a family of the increased tax on their food purchases, hence the relief was of more importance to those in the lower income brackets.

**RATING (OF PROPERTY)** — The method of rating real property within the administrative area of a local authority is a feature of the system whereby the expenditures incurred by the authority on providing various services to those working or dwelling within its boundaries are divided "rateably" among the occupiers of property in proportion to the annual value or capital value of such properties. In Britain rates charged on property are levied at a lower poundage (percentage) on residential than on commercial and industrial property and are not charged at all on agricultural land and buildings. (See also RATE REBATES and LOCAL RATES AND TAXES.)

**REAL ESTATE TAX** — See PROPERTY TAX.

**REAL PROPERTY TAX** — A tax upon the owners or occupiers of real property within the area of jurisdiction of the taxing authority. (See PROPERTY TAX.)

**RE-ALIGNMENT** — The term has been used as a euphemism for the process whereby, under a general amnesty for tax fraud, a taxpayer may revise past declarations of income (or re-align them) in accordance with the actual figures, usually incurring only a modified penalty, and always with the guarantee of freedom from the risk of imprisonment for fraud. (See also COMMUTATION.) Since the capacity of any tax department to conduct lengthy Court proceedings in the many cases of understatement of income is limited, the use of some form of "out of Court" settlement rectifying or re-aligning (or some other euphemism) the tax in the years of understatement is customary.

**REALISATION** — The realisation of an asset, normally by exchanging it for money, is a transaction which is relevant for the levying of various kinds of tax, e.g. capital gains tax charged on the gain resulting from the realisation or disposal of property at a price higher than was paid for it. Sometimes a tax law deems various events to have resulted in a realisation, e.g. a gift of an asset to another person, or its bequest on death, is sometimes regarded as a realisation, leading to a charge to capital gains tax where the value at the time of transmission is greater than the cost price. See also FIRST LETTING TAX regarding the deeming of letting, instead of selling real property, as being a form of realisation.

**REBATES, EXPORT: INTERNAL TAXATION** — See EXPORT REBATES.

**RECAPTURE** — A term used in the U.S.A. and Canada to denote the subsequent withdrawal or cancellation of all or part of a relief formerly given. Examples include the withdrawal (U.S.A.) of the RESIDENTIAL PURCHASE INCENTIVE (q.v.) where the new residence is re-sold within 36 months of acquisition, and of foreign oil-related losses, where in subsequent years foreign oil-related income is earned. In Canada disposal proceeds of depreciated assets are taxable to the extent to which they exceed UN-DEPRECIATED CAPITAL COST * (q.v.), and there are similar provisions under other nomenclature in the tax codes of other countries. For example, STOCK RELIEF in the U.K. may be subsequently "recaptured" in certain circumstances.

* The recapture will not exceed relief already allowed.

**RECEIPTS** — The receipts or takings, or cash inflow from the sale of goods and services, of a business or profession may sometimes form the basis for taxation (see CASH BASIS), e.g. a simplified method of computing profits as receipts less payments may be allowed in the case of a small trader whose accounting records make it difficult to adopt a more sophisticated method. The option of paying tax upon receipts instead of sales may also be allowed for sales tax purposes under certain sales tax regimes. "Receipt", in the other sense of a document acknowledgeing that money has been received in return for goods or services, has relevance to tax administration in that some countries require receipts of some form to be given for all transactions, copies being compulsorily kept by the traders so that checks may be made by tax officials of the accuracy of a trader's records. See also GROSS RECEIPTS TAX, LOTTERIES FOR CONSUMER.

**RECHTSPERSONENBELASTING** — (Belgium) Income tax on public bodies (State and local authorities) and on non-profit enterprises.

**RECOGNITION (OF LOSS, ETC.)** — A term used in the U.S.A. and elsewhere to denote the acceptance of a loss, or various other types of expenditure, as qualifying for tax relief.

**RECOVERY (OF BAD DEBT, ETC.)** — While a deduction is normally afforded from income taxation for a commercial debt written off as "bad" (see BAD DEBTS), if the debt is subsequently recovered the amount received is regarded as taxable. (See also RECAPTURE.)

**REDISTRIBUTIVE LEVY** — A tax imposed by a government, intended to fall most heavily on the rich, to provide revenue to finance social welfare expenditure intended to benefit mainly the poor. The term applies particularly to direct taxes such as income tax, surtax, wealth tax, and death duties.

**REDUCING BALANCE METHOD** — A way of calculating depreciation allowances whereby a fixed percentage rate of depreciation is applied initially to the cost of a depreciating asset which qualifies for tax relief and subsequently to the cost as reduced by the depreciation allowance for previous years. The system, also known as the DECLINING BALANCE METHOD, purports to grant allowances on the basis of the actual value of the asset, the market value of which obviously depreciates (other things being equal) by reason of the wear and tear which takes place during each year of use. (See also WRITTEN DOWN VALUE and, by contrast, STRAIGHT LINE METHOD, SUM OF THE YEARS' DIGITS METHOD, and UNIT OF PRODUCTION METHOD.)

**REDUNDANCY PAYMENTS** — In the U.K., income tax exemption is afforded in respect of payments by an employer to an employee who has been continuously employed for a certain period, but has been dismissed as redundant with compensation. (see also LOSS OF OFFICE, SEVERANCE PAYMENTS.)

**REGIONAL EMPLOYMENT PREMIUM (R.E.P.)** — Under the provisions of the SELECTIVE EMPLOYMENT TAX (S.E.T. — q.v.) in Britain, the contributions by employers, based on a fixed sum for each employee, were refunded wholly to manufacturing industries in the period from 1966 to March 1968 and an additional payment was also made. The additional payments or premiums ceased in March 1968. Thereafter when manufacturing industry was carried on in Development Areas where the government wished to encourage the siting of industry, Regional Employment Premiums, i.e. payments in excess of the tax initially paid by way of S.E.T., were made during the period April 1968 to March 1970 (to March 1971 in Northern Ireland). Premiums were paid for some time as a subsidy after the halving of S.E.T. contributions in July 1971, and their abolition in April 1973.

**REGISTRATIERECHT** — (Belgium) Registration duty.

**REGISTRATION DUES AND TAXES** — Certain types of trade, business or profession are required to register for various purposes, which may include the supervision of the activities under statutes relating to public health, public order, fire safety regulations, etc. Sometimes the registration is subject to an annual levy which may be little more than a sum sufficient to cover the administrative costs of exercising the various forms of statutory control. In some countries, the registration requirement relates to all forms of gainful activity by self-employed traders, professionals and artisans, and such registration may also be required in connection with a cascade tax or under a V.A.T. system.

**REGISTRATION FOR SALES TAX** — A feature of many single stage sales taxes is that traders who deal in taxable goods are required to register and are then allowed to buy such goods tax-free, subject to their accounting for tax on re-sale of the goods. The tax is then payable only on sales to non-registered traders and to consumers. (See also RING.)

**REGRESSION** — A tax is said to be regressive (in contrast to progressive — see GRADUATION) when the burden of paying it falls more heavily on the lower income groups. As far as direct taxes are concerned, regression is avoided by establishing exemption limits and providing reliefs for dependents and commitments such as superannuation payments or health insurance contributions, and sometimes for premiums on life assurance policies. Indirect taxes on commodities and services are more likely than direct taxes to be regressive, but the regressive effect of such taxes may be mitigated by exemption, for example, of food and other necessities, the cost of medical services and medicines, from indirect taxation, or the imposition of lower than average rates of tax on such goods and services. Nowadays, under state welfare provisions it is becoming more usual to pay cash allowances to those whose incomes are below an official "poverty line". (See also NEGATIVE INCOME TAX.)

**REGULATED INVESTMENT COMPANIES** — These companies, also known as "Mutual Funds", formed under U.S.A. law, make diversified investments with funds provided by their investors to whom they distribute dividends and capital gains realised. Special tax rules apply so that the investor does not incur additional taxation by the interposition of another company between him and the ultimate investments. Such companies are broadly similar to UNIT TRUSTS (q.v.) when in "Open End" form, but may also be "Closed End" in which case the shares issued to the public are fixed in number and traded on the Stock Exchange.

**REGULATOR** — See CUSTOMS REGULATOR and REGULATOR TAX.

**REGULATOR TAX** — The Regulator Tax (also known as the "Wobble" Tax) was introduced in Holland early in 1971 as a mechanism for adding a surcharge to, or making a deduction from, the main revenue taxes, viz., income tax, corporation tax, petrol duty, motor car sales levy and VAT, which together produce 80 percent of tax revenue. Originally levied as a surcharge at 5 percent the regulator was reduced to (an addition of) 3 percent on 1 July 1972 and has not so far been applied to VAT.

**RE-INVESTMENT PERIOD** — In granting ROLL-OVER RELIEF (q.v.) it is normally stipulated that the replacement asset or investment must be acquired within a limited period before or after disposal of the asset which gives rise to the potential capital gains tax liability. In the U.S.A., for example, on sale of a residence the new home must be acquired within 18 months of the disposal, or in case of a newly-constructed home, within 24 months.

**RE-INVESTMENT RELIEF** — Roll-over relief in respect of the purchase of a new investment after realising a capital gain on disposal of a previous investment, allowed in Belgium.

**RELIEF OF DISTRESS, POVERTY, ETC.** — The classic definition of a charity (see CHARITIES, DONATIONS; CHARITIES EXEMPTION) is that it has as its main purpose one or more of certain objects. These objects have been defined as the advancement of education, of religion, the relief of distress, poverty, etc., and the serving of purposes beneficial to the community.

**RELIEFS** — In personal income tax systems it is usual to make various deductions, based on the personal circumstances of the individual, before applying graduated tax rates to the rest of his income. (See CHILD, EARNED INCOME RELIEF, HOUSEKEEPER, SMALL INCOME RELIEF, SPOUSE.)

**RELIGIOUS TAXES** — Certain types of tax, the proceeds of which are used for religious purposes, are occasionally encountered even in secular states. In countries where, for example, Islam is the official religion, there may be a liability to pay FITRAH and ZAKAT (q.v.), and in Britain at one time TITHES (q.v.) were payable to the Church. In Federal Germany there are currently statutory liabilities to subscribe to one or other of various recognised religions, these payments being deductible for income tax purposes. Income tax relief is given in some other countries for voluntary or contractual contributions to approved religious bodies or to their social service activities.

**REMISSION ON REVENUE ERROR** — A system, recently inaugurated in the U.K., where tax has been undercharged through no fault of the taxpayer and because of a departmental error. The relief is only given where the taxpayer's income is below certain limits, and only where the tax arrears resulting from the error have not been notified to the taxpayer in the year following that in which the under assessment took place. (See also ERROR, DEPARTMENTAL, and ERROR OR MISTAKE.)

**REMITTANCE BASIS** — Where a person lives in one country but derives income from others, the foreign income may be taxed either on the amount actually arising, or the amount remitted to the country of residence. The latter method — the remittance basis — relates the person's tax more nearly to the amount of income actually available for him to spend in the country of residence and may be administratively easier to manage since the Tax Department is not then concerned with unremitted foreign income. Where foreign income is remitted, the tax liability normally takes account of foreign tax paid thereon (see FOREIGN TAX RELIEF, (CREDIT)). In some countries the remittance basis applies to persons resident there but not domiciled, or not ORDINARILY RESIDENT (q.v.), in the taxing country.

**REMOVAL EXPENSES** — In some countries the expenses incurred by an employee, after ceasing one employment, in moving his residence to another part of the country to obtain another job are not deductible because they are not regarded as incurred in connection with one particular employment (see WHOLLY, EXCLUSIVELY, and NECESSARILY). In Canada and the U.S.A. such expenses are deductible in computing employment income, and in the U.S.A. the relief is also granted to a businessman or professional who changes his place of business.

**RENEWAL OF ASSETS** — Although DEPRECIATION ALLOWANCES (q.v.) are generally granted in tax code for assets which depreciate in use while employed in producing profits, smaller items, such as hand tools, are sometimes dealt with on a renewals basis, i.e. purchases are deducted, sales credited and the value of the stock of such items at beginning and end of the accounting period is also brought into the calculation.
Where renewal (replacement) of an asset involves realisation of a capital gain on the old asset, ROLL-OVER RELIEF (q.v.) may be due.

**RENTS, MINERAL** — The rent paid for the right to exploit mineral resources, which may be in the form of a royalty, or charge on the *volume* or *weight* of mineral-bearing material extracted (see MINERAL ROYALTIES), or as a rent for an *area* of mineral-bearing land (or sea-bed) exploited. Such rents are normally deductible in computing profits from mineral production. (See also WASTING ASSETS.)

**REPLACEMENT-COST DEPRECIATION** — In circumstances of monetary inflation, depreciation allowances based on the historic cost of an asset may be regarded as inadequate where the cost of replacing the asset has increased sharply in money terms. If, for example, replacement cost has doubled in a particular tax year, and the value of money halved, it would be necessary to double the depreciation allowance in order to give effect to the appropriate allowance in real terms. There are obvious administrative difficulties in trying to introduce a replacement-cost depreciation system, since replacement cost may vary for technological reasons as well as because of monetary inflation. If such a system is adopted, however, rough justice may be done by using a general price index as a factor to convert "historic" allowances to take account of the degree of inflation.

**REPLACEMENT OF ASSETS** — See RENEWAL OF ASSETS.

**REPORT DEFICITAIRE** — (France) Carry forward of losses.

**REPRESENTATIONAL OCCUPATION** — See OCCUPATION, REPRESENTATIONAL.

**RESALE PRICE MAINTENANCE (R.P.M.)** — The system whereby manufacturers fix retail prices for their products, traders being discouraged or even prohibited from selling goods at less than the fixed price. This practice deprives the consumer of the full advantage of competition, as a result of which certain businesses (such as supermarkets, chain stores or discount houses) may be prepared to sell goods at less than the recommended price. Where prices are effectively controlled by manufacturers, or some other authority, there may be some slight advantage to the tax department concerned with administering income tax, since if the profit margin is fixed, the gross profit on selling the commodity will also be precisely ascertainable.

**RESEARCH** — Expenditure on research and development is normally allowed for tax purposes, either as a current deduction where it relates to existing products and processes, or as depreciation or amortisation allowances where it results in the creation of a new product or process. In Italy, for example, if research is abandoned without producing results the balance of expenditure may be written off in the year research was terminated. If successful, the expenditure may be written off over five years. (See PATENTS.)

**RESERVES RELIEF** — On general income tax principles, deductions for amounts placed to reserve are restricted mainly to specific bad debts reserves where trading debts owed to the trader, which are regarded as likely to prove wholly or partially irrecoverable, are individually valued on the accounting date. Some countries, however, provide special reliefs such as deferral of tax by way of incentive, in respect of amounts placed to reserve against some future commitment such as the incurring of capital expenditure on new premises, plant and machinery. (See BAD DEBTS, BUSINESS CYCLE EQUALISATION RESERVES.)

**RESIDENCE, CHANGE OF** — See REMOVAL EXPENSES.

**RESIDENCE, FISCAL** — The concept of residence is important for income taxes in that a resident is usually accorded RELIEFS (q.v.) from income in computing his tax, but may also be taxed on his world income instead of merely the income arising in the country of residence. A non-resident would only pay on the income arising in the country, but would probably be denied reliefs except any provided by a DOUBLE TAXATION (q.v.) treaty.

**RESIDENT ALIEN** — A concept in U.S.A. tax law — U.S. passport-holders are subject to U.S. tax on world income, wherever resident, and the treatment of those resident in the U.S.A. varies according to whether they are or are not U.S. citizens. Elsewhere the criteria of domicile and ORDINARILY RESIDENCE (q.v.), etc. are used instead.

**RESIDENTIAL ENERGY CREDIT** — To encourage economy in the use of fuel in the U.S.A., tax relief is granted to taxpayers who install energy-saving components in their homes or who instal equipment to produce solar, geothermal, or wind energy. The relief is for expenditure incurred after 19 April 1977 and will expire on 31 December 1985.

**RESIDENTIAL PURCHASE INCENTIVE** — A tax incentive granted in the U.S.A. for newly-constructed residences, bought between March and December 1975. The relief was 5 percent of the purchase price, subject to a maximum tax credit of $2,000. The credit was subject to RECAPTURE (q.v.) if the residence was sold within 36 months and there were other restrictions. In the U.K. an incentive to home purchase consists in the deduction from other income for tax purposes of interest paid on mortgages entered into to finance home purchase without any tax being payable on the notional annual value of the home to its owner.

**RESIDENTS TAX** — In countries which have SCHEDULAR TAX SYSTEMS (q.v.) whereby income is charged at a flat rate of tax, supplementing the basic levy with additional graduated tax on total income, such extra liability may be known as a "supplementary" or "residents" tax. The latter term is particularly appropriate where the country seeks to apply graduated tax only to those residing within its borders, charging merely a flat rate of tax on income accruing to non-residents.

**RESOURCE RENT (TAX)** — A concept formulated by economists to the effect that taxation on the exploitation of natural resources should be related to the comparative richness of particular resources, rather than at a flat rate on the resources as a whole. The concept is difficult to put into practice, though it has been broadly adopted, e.g. in MALAYSIA'S TIMBER PROFITS TAX and TIN PROFITS TAX (q.v.).

**RESTAURANT TAX** — A tax sometimes levied specifically on restaurants, usually as a percentage of gross sales, but sometimes — particularly where entertainment is provided — on a per capita basis on the customers served in the restaurant. Under some types of sales tax regime, e.g. V.A.T., services provided by restaurants are taxed in common with the services, provided by other businesses as a feature of the taxation of services in general. (See also CABARET TAX.)

**RETAIL EXPORTS SCHEME** — A scheme operated in connection with Value Added Taxes whereby retailers may arrange for the sale of goods to tourists free of tax and customs duty, the goods being delivered to the tourist on leaving the country. Another such scheme allows the tourist to purchase goods in department stores or other shops at a tax-inclusive price but reclaim the V.A.T. (only) at a customs or tax office on leaving the country.

**RETAIL SALES DRIVE** — An organised physical check by Customs, V.A.T., or Sales Tax administration staff, of goods on sale in retail shops to confirm that the goods have duly borne any customs duty, sales tax, etc. which is supposed to apply to them.

**RETAIL SALES TAX** — An ad valorem tax on sales of goods to consumers, whether by retailers or other traders. Retail sales taxes have been levied in a number of countries, notably the individual states of the U.S.A. and the provinces of Canada, and more recently (the "turnover tax") in Eire, where it has, however, been superseded by V.A.T.

**RETENUE À LA SOURCE** — (France) Withholding of tax at source.

**RETIREMENT** — The term has two meanings relevant to taxation: (a) regarding individuals, the cessation of employment at the age of 60, 65 or whatever is the customary retirement age in the relevant country, usually followed by receiving a pension; (b) in the U.S.A. the term is used to refer to the taking out of usage items of plant, machinery, etc.

**RETIREMENT ACCOUNTS, INDIVIDUAL** — Individual Retirement Accounts (IRAs) were authorised in the U.S.A. by the Employee Retirement Security Act of 1974 as qualifying for favourable tax treatment. Taxpayers not covered by private pension schemes could set up their own retirement provisions and could deduct payments therefor up to 15 percent of income, subject to a maximum deduction of $1,500, and the accumulating funds would be tax-free. Subsequent legislation has liberalised the original terms in various ways, e.g. ROLL-OVER RELIEF (q.v.) is given when an employee leaves one employment but puts the IRA funds accumulated into the new provision in his subsequent occupation.

**RETIREMENT ANNUITY** — Most tax administrations allow deductions from current income in respect of annual contributions under contracts to provide pensions or annuities on retirement. The net effect of paying out such moneys so as to receive income during retirement is a deferment of part of the taxpayer's income. The tax treatment of allowing deductions and then taxing annuities or pensions in due course is the logical one of taxing the taxpayer at all times on his actual net income.

**RETIREMENT GRATUITIES** — Some "approved" pension schemes provide not only for a pension, but also for a lump sum payment at the end of active employment, which may or may not involve commutation of part of the gross pension payable. The object is usually to help the ex-employee to set up a new home or meet other expenses which may be incurred in the transition from employment to retirement. In general such "contractual" payments do not incur tax. (See also GOLDEN BOWLER, GOLDEN HANDSHAKE, REDUNDANCY PAYMENTS.)

**RETIREMENT RELIEF** — In the U.K. system of CAPITAL GAINS TAX (q.v.), exemption is given of the first £20,000 of gains resulting from disposal of assets by a taxpayer on retirement from business at age 65 or more. There is also relief to a smaller degree for those retiring at age 60 upwards.

[to be continued]

# Bibliography

# Books

*The publications listed in this bibliography have recently been acquired by the Bureau's library which will gladly supply further information upon request (please quote the reference numbers). They should, however, be ordered through a bookseller or direct from the publisher indicated, and not through the Bureau.*

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## AUSTRALIA

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By A. Tiberghien. Brussels, CED-Samdom, 1979. 687 pp.
Manual providing description of fiscal law and the taxes levied in Belgium. The material is up to date as of March 1, 1979. (B. 102.301)

### L'INDICATEUR FISCAL

Editor: Francis Bailleux in cooperation with others. Brussels, CED-Samsom, 1979.
First part of a loose-leaf reference guide explaining the major taxes levied in Belgium, such as the individual income tax, corporate income tax, the income tax on legal entities and the tax on value added. (B. 102.233)

## BRAZIL

### BRITISH AND GERMAN DIRECT INVESTMENTS IN BRAZIL

By Peter-Uwe Schliemann. Hamburg, Institut für Iberoamerika-Kunde, 1979. Private Auslandsinvestitionen in Lateinamerika, No. 7. 82 pp.
Study providing a comparison of the performance and experience between British and German Federal Republic investors in Brazil. (B. 15.933)

### MANUAL DE NORMAS PARA TRIBUTAÇAO DAS PESSOAS JURIDICAS

Imposto sobre a Renda e Proventos de Qualquer Natureza. Brasilia, Ministério da Fazenda, Secretaria da Receita Federal, 1979.
Loose-leaf service on the taxation of corporations, indicating the legal sources. (B. 15.894)

## CANADA

### CANADIAN INCOME TAXATION

By Erwin C. Harris. Toronto, Butterworths, 1979. 840 pp., £19.30.
Introductory textbook on Canadian income taxation for students of accounting and business in universities and various professional training programs. Leading regulations, case law, articles and departmental announcements up to December 31, 1978 are incorporated in the treatise. (B. 102.103)

### RESIDENTIAL PROPERTY TAX RELIEF IN ONTARIO

By R.M. Bird and N.E. Slack. Toronto, University of Toronto Press, 1978. 188 pp.
In-depth study of the incidence of the property tax and the property tax credit in Ontario. (B. 102.171)

### TAX EXPENDITURES: AN EXAMINATION OF TAX INCENTIVES AND TAX PREFERENCES IN THE CANADIAN FEDERAL INCOME TAX SYSTEM

By Roger S. Smith. Toronto, Canadian Tax Foundation, 1979. 175 pp.
Study identifying and measuring tax expenditures (subsidies) in the Canadian tax system. (B. 102.266)

### UNITED KINGDOM/CANADA PROPOSED TAX TREATY

Summary — Analysis — Text. By Nicholas J. Seed and David G. Pangbourne. London, Touche Ross & Co., 1979. 60 pp.
Summary and text of the comprehensive double taxation treaty between Canada and the United Kingdom signed September 8, 1978 and off-print of an article on the treaty published in the Canadian Tax Journal, January-February 1979 issue. (B. 102.107)

## COMMON MARKET (EEC)

### ARMONIZACION TRIBUTARIA

El I.V.A. en la Comunidad Economica Europea. By Raúl Luis d'Alessandro. Montevideo. Dirección General Impositiva, Dirección de Sistemas de Apoyo, 1979. 127 pp.
Paper explaining the VAT legislation in the European Common Market, with particular attention to the taxation of agriculture, financial operations and immovable property transactions. (B. 102.160)

### BUSINESS ENTERPRISES IN THE EEC

By J.C. Pollock. The Hague, Fenedex, 1979. 46 pp.
Description of how to establish a business enterprise in one of the EEC member countries, and taxation thereof. (B. 102.174)

### PROBLEMES FISCAUX DES MAISONS HISTORIQUES DANS LES ETATS DE LA COMMUNAUTE ECONOMIQUE EUROPEENNE

By I. Claeys Bouuaert. Brussels, Commission of the European Communities, 1979. 154 pp.
Study on the taxation of historic houses owned by private persons in the member states of the European Communities. (B. 102.207)

### VALUE ADDED TAX

The evolution in the European Economic Community and the application in the United Kingdom. By Miltiades Miltiadou. Amsterdam, Europa Instituut, University of Amsterdam, 1979. 63 pp. (B. 102.268)

### VERDRAGEN TOT OPRICHTING VAN DE EUROPESE GEMEENSCHAPPEN

Verdragen tot wijziging van deze Verdragen. Teksten betreffende de Gemeenschappen. Verkorte uitgave. Luxembourg, Europese Gemeenschappen, 1979. 560 pp.
Abridged edition of a compendium containing the texts of the most important agreements for the establishment of the European Communities. (B. 102.190)

## DENMARK

### DIRECT TAXATION IN DENMARK

A brief survey. Third edition. Copenhagen, The Inland Revenue Department, 1979. 65 pp.
Explanation of the principal provisions governing various kinds of direct taxation of individuals and companies in Denmark. (B. 102.166/166A)

### OECD ECONOMIC SURVEYS: DENMARK

Paris, Organisation for Economic Co-operation and Development, 1979. 68 pp., 12 Fr.Frs. (B. 102.131)

### SETTING UP IN DENMARK

Copenhagen, Copenhagen Handelsbank, 1978. 43 pp.
Brochure presenting a business survey of economic, legal and financial aspects of foreign investment, including taxation in Denmark. A German version is also available. (B. 102.060/061)

## EASTERN EUROPE

### LES CONTRATS DE LICENCE EN DROIT SOCIALISTE

By Alexandre Vida. Paris, Librairies Techniques, 1978. 216 pp.
Monograph explaining the specific aspects of licence contracts with Eastern European countries. The book also contains a comparative analysis of the specific legal provisions of the individual countries, including the taxation provisions. The texts of standard contracts used in these countries are appended. (B. 102.079)

## EUROPE

### FISCALITE EN EUROPE

Confédération Fiscale Européenne (C.F.E.). Deventer, Kluwer, 1979. 258 pp.
Proceedings and contributions of the First European Tax Consultants' Congress held in Strasbourg in 1978. The reports are published in the French language. (They have also been published in the German language.) Subjects dealt with are: The taxation of investment in the EEC; Company taxation in the EEC taking into consideration double taxation agreements, the net wealth tax and the cooperation of tax consultants. (B. 102.251)

### GEMEINSCHAFTSUNTERNEHMEN (JOINT VENTURE — FILIALE COMMUNE) IM KONZERN- UND KARTELLRECHT

By Ernst-Joachim Mestmäcker, Jean-Bernard Blaise and David T. Donaldson. Frankfurt, Alfred Metzner Verlag, 1979. Arbeiten zur Rechtsvergleichung, No. 93. 80 pp., 19.80 DM.
Booklet containing the German, French and English national reports of a group of experts dealing with the company law aspects of joint ventures within the scope of the legal provisions in these countries concerning concerns and cartels. (B. 102.238)

### TAXATION OF INTERCOMPANY TRANSACTIONS IN SELECTED COUNTRIES IN EUROPE AND USA

Deventer, Kluwer, 1979. 119 pp., 30 Dfl.
Survey of intercompany transactions by multinational companies in selected European countries (i.e. Austria, Belgium, Denmark, France, German Federal Republic, Ireland, Italy, the Netherlands, Norway, Spain, Switzerland, the United Kingdom) and the U.S.A. (B. 102.167)

## FRANCE

### BUSINESS STUDY: FRANCE

London, Touche Ross International, 1979. 212 pp.
Study on doing business in France describing investment opportunities, forms of business entities, accounting and auditing conditions and taxation in France. (B. 102.127)

### COMMENT GERER VOTRE PORTEFEUILLE

La Bourse. By Gérard Vidalenche. 9e Edition, à jour au 1er janvier 1979. Paris, Editions J. Delmas et Cie., 1979. Serie: "Ce qu'il vous faut savoir". 230 pp.
Reference guide explaining how to administer one's portfolio at the stock exchange. Consideration to European, Japanese and U.S.A. stock exchanges is given. (B. 102.128)

### FISCALITE IMMOBILIERE

Deuxième édition. By Jean Schmidt. Paris, Librairies Techniques, 1979. 385 pp.
Monograph dealing with all the various taxation aspects of real property under the French tax system. (B. 102.305)

### FISCALITE PRATIQUE DES AFFAIRES

Avec 25 études de cas dont annales D.E.C.S. 1975-1977. 2 Volumes. By Philippe Colin, Gilles Gervaise and Thierry Lamorlette. Paris, Economica, 1979. 751 + 132 pp.
Fourth edition of textbook entitled "Practical Tax Problems" in two volumes explaining the taxes levied under the French tax system. Examples and printed statutes are contained in Volume I. Volume II consists of 25 examination questions and the solutions thereto. (B. 102.306/307)

### LE REGIME FISCAL DE LA PROPRIETE INDUSTRIELLE

By Z. Weinstein. Paris, J. Delmas et Cie., 1977. 240 pp.
Second revised edition of book on the taxation of industrial property under French tax law (with respect to income, value added tax, registration duty). (B. 102.080)

### L'IMPOSITION DES PROFITS DE BOURSE ET AUTRES GAINS SUR TITRES

By Pierre Courtois. Paris, Librairies Techniques (Litec), 1979. 244 pp.
Study describing the capital gains tax on gains derived from operation on the stock exchange. In addition, the taxation of capital gains derived from other transfers of title to assets such as participation in a real property company is appended. Relevant texts of statutes are included. (B. 102.225)

### POUVOIR ET FINANCE D'ENTREPRISE

Droit et pratiques. By Michel Fleuriet. Paris, Dalloz, 1977. 207 pp.
Study assessing the legal aspects and practices arising from financing acquisitions of enterprises and the shareholder's voting rights. Tax aspects are dealt with. (B. 102.257)

### VALEUR ET REGROUPEMENTS DES ENTREPRISES

Méthodes et pratiques. By Didier Pene. Paris, Dalloz, 1979. 271 pp.
Study assessing the characteristics of performance arising from enterprises involved in acquisitions. Tax aspects are dealt with. (B. 102.258)

### LA VERIFICATION FISCALE

By Philippe Colin. Paris, Economica, 1979. 302 pp.
Monograph describing verification by the tax administration in France. (B. 102.308)

## GERMAN FEDERAL REPUBLIC

### ALLGEMEINES STEUERRECHT IN EINZELGESETZEN

Zugleich ein Beitrag zur Gesetzgebungstechnik. By Hermann-Josef Thebrath. Cologne. Peter Deubner Verlag, 1979. 207 pp., 59 DM.
Study examining the questions concerning the content and the impact of tax provisions of a general nature which are not regulated by the 1977 Fiscal Code but by separate laws. The author also discusses the question, to what extent can the role of these separate laws be taken over by the Fiscal Code by including such special provisions in that law? (B. 102.293)

### AO-HANDBUCH

Handbuch des steuerlichen Verwaltungs- und Verfahrensrechts 1979. Munich, Verlag C.H. Beck, 1979. 699 pp., 58 DM.
Compilation of the text of the 1977 German Fiscal Code for the assessment year 1979 with related material. (B. 102.085)

### DIE BESTEUERUNG DES LEBENSEINKOMMENS

By Johannes Hackmann. Tübingen, J.C.B. Mohr (Paul Siebeck), 1979. 371 pp., 148 DM.
Discussion of the theoretical aspects of the various procedures applied concerning the taxation of "accumulated life income". (B. 102. 237)

### EINKOMMENSTEUER — RICHTLINIEN

Einkommensteuergesetz und Einkommensteuer DV. 3., neubearbeitete Auflage. Munich, Verlag C.H. Beck, 1979. 400 pp., 16.80 DM.
This book contains the texts of the German income tax law, the income tax directives, up to date as per May 1, 1979. (B. 102.083)

### DAS ERSTATTUNGSRECHT DER ABGABENORDNUNG 1977

By Walter Drenseck. Cologne, Peter Deubner Verlag, 1979. Steuerwissenschaft, Band 7. 121 pp., 38 DM.
Monograph dealing with the various questions concerning claims on refund of taxes under the new German 1977 Fiscal Code. (B. 102.291)

### GEWERBESTEUER

2. Auflage. By H-R. Pohlmann. Bonn, Stollfuss Verlag, 1979. Sammlung "Der Steuersparer", Band 16. 126 pp., 10.80 DM.
Practical guide explaining the most important provisions of the German trade tax, e.g. the tax-free amounts (as increased as per January 1, 1980), tax exemptions, taxable base, rates, etc. (B. 102.194)

### GRUNDSTEUERGESETZ UND II. WOHNUNGSBAUGESETZ

(§§ 92 ff.) mit Nebengesetzen, Richtlinien und Verwaltungsanweisungen. Kommentar. 4., neubearbeitete und erweiterte Auflage. By Max Troll. Munich, Verlag Franz Vahlen, 1979. 594 pp., 118 DM.
This commentary on the real estate tax is written by the real estate expert of the German Ministry of Finance. Especially extensively discussed are the following subjects: the new real estate tax regulations 1978, the adaptation to the new Fiscal Code, and the real estate tax provisions of the 2nd Housing Law. (B. 102.087)

### HANDBUCH DER FINANZWISSENSCHAFT

Dritte, gänzlich neubearbeitete Auflage. Lieferung 22-26. By Norbert Andel and Heinz Haller. Tübingen, J.C.B. Mohr (Paul Siebeck), 1979. 400 pp.
Third revised edition of a handbook on public finance. This supplement particularly deals with a detailed discussion of income and turnover taxes, as well as with parafiscal budgetary receipts. (B. 102.231)

### KIRCHENSTEUERRECHT UND KIRCHENSTEUERPRAXIS IN DEN BUNDESLÄNDERN

By Jörg Giloy. Stuttgart, Forkel Verlag, 1978. 288 pp.
Compendium explaining the theoretical and practical aspects of levying the so-called "church tax" in the German "Länder". (B. 102.193)

### KÖRPERSCHAFTSTEUER — ERKLÄRUNGEN FUR 1978

By Hans-Joachim Schad, Horst Eversberg and Jürgen Wagner. Düsseldorf, IdW Verlag, 1979. 271 pp., 33 DM.
Practical guide for filing 1978 corporate income tax returns. (B. 102.236)

### MITARBEITENDE KOMMANDITISTEN UND STILLE GESELLSCHAFTER IM STEUERRECHT

By Klaus Esser. Cologne, Verlag Dr. Otto Schmidt, 1978. Rechtsfragen der Handelsgesellschaften, Heft 37. 248 pp., 32 DM.
Monograph discussing the income tax treatment of partners in a limited partnership and a silent partnership under German law. (B. 102.195)

### REALSTEUERN

Ein Leitfaden für die kommunale Steuerverwaltung. By Max Troll. Stuttgart, Forkel Verlag, 1979. 254 pp.
Practical guide explaining the most important aspects of taxes which may be levied by municipalities in Germany, e.g. the multiple to the trade tax and real property tax. (B. 102.192)

### STEUER-FORMULAR-HANDBUCH

Formulare — Muster — Erläuterungen für die Steuerpraxis. By Helmar Fichtelmann, Rolf Mittelbach, Rolf Petzoldt and Dieter Schulze zur Wiesche. Cologne, Peter Deubner Verlag, 1979. 550 pp., 128 DM.
Handbook reproducing and explaining forms used in tax matters, particularly concerning procedures to be followed by taxpayers requesting special treatment in payment of tax due, or appealing to the Courts in the case of complaints on decisions by the tax authorities, or forms used for the establishment of legal forms of enterprises. The book also discusses the practical impact of these forms. (B. 102.294)

### DIE STEUERHINTERZIEHUNG (PAR. 370 AO 1977)

Eine strafrechtliche, kriminologische und kriminalistische Untersuchung unter besonderer Berücksichtigung von Vermögens- und Einnahmesteuerhinterziehungen. 2. unveränderte Auflage. By Carola Seckel. Lübeck, Verlag Max Schmidt-Römhild, 1979. Kriminalwissenschaftliche Abhandlungen, Band 10. 324 pp., 78 DM.
Study examining the criminal law and criminological aspects of tax avoidance and tax evasion, with emphasis on the avoidance and evasion of individual and corporate income tax and net worth tax. The author also discusses the existing provisions in the Fiscal Code 1977 concerning fiscal punishments and fines and takes a position against these provisions. (B. 102.290)

### STEUERRECHT

Ein systematischer Grundriss. 7., überarbeitete und erweiterte Auflage. By Klaus Tipke. Cologne, Verlag Dr. Otto Schmidt, 1979. 620 pp., 64 DM.
This book provides a comprehensive description of the tax law of the Federal Republic of Germany. The concepts are systematically presented in theory and the practical application is also demonstrated. (B. 102.292)

### UNTERNEHMUNGSBEWERTUNG UND STEUERN

3., neubearbeitete Auflage. By Carl Helbling. Düsseldorf, IdW-Verlag, 1979. 487 pp., 78 DM.
Study on the various concepts of valuation of business assets for purposes of taxation with special attention to the problems of this matter in German-Swiss business relations. (B. 102.196)

### ZIVILPROZESSORDNUNG

12. Auflage. By Richard Zöller. Cologne, Verlag Dr. Otto Schmidt, 1979. 2356 pp.
Twelfth revised edition of commentary on German civil procedure. Due to the author's practical experience, the book follows a practical approach. The following new legislation is worked in: "Vereinfachungsnovelle", e.g. law simplifying civil procedure; marriage and family law reform, changes in foreclosure proceedings. (B. 102.081)

## GREECE

### OECD ECONOMIC SURVEYS: GREECE

Paris, Organisation for Economic Co-operation and Development, 1979. 72 pp., 12 Fr.Frs. (B. 102.172)

## ICELAND

### TAXES IN ICELAND 1979

Short description of the taxation of individuals and companies in Iceland 1979 (Assessment year 1979: Tax year (income year) 1978). Prepared by S. Thorbjörnsson, Director of Internal Revenue, September 1979. Reykjavik, Government Printer, 1979. 17 pp. (B. 102.221)

## INDONESIA

### PAKET 20 APRIL 1979

Tarif baru. Pajak Penjualan, Bea Masuk & PPn-Impor. Jakarta, Yayasan Bina Pajak, 1979. 55 pp.
The April 20, 1979 package concerning the reform of the sales tax on domestic sales, import duties and sales tax on importation of goods. (B. 51.447)

## INTERNATIONAL

### ADVANCED INTERNATIONAL TAX PLANNING

The 11th Multi-choice Symposium held in Amsterdam from 24 to 26 October 1979 convened by Seminar Services International. Volume I and Volume II. Lausanne, Seminar Services, 1979. 650 pp.
Text of contributions on various subjects. Volume I includes: "The use of double taxation agreements" by Terry M. Browne Acca; "Doppelbesteuerungsabkommen und Betriebstättenbegriff des OECD-Musterabkommens" by B. Heider; "Taxation of plant constructions and other constructions abroad" by J. van Hoorn Jr. Volume II includes: "Tax treaties and tax planning: a comparative study of recent cases and rulings" by M. Edwardes-Ker; "International leasing operations, holding and finance companies" by K.J. McLachlan. (B. 102.264)

### ANNUAL REPORT ON EXCHANGE ARRANGEMENTS AND EXCHANGE RESTRICTIONS 1979

Washington, International Monetary Fund, 1979. 470 pp.
The material is updated as of December 31, 1978. (B. 102.235)

### BASIC PROBLEMS IN INTERNATIONAL FISCAL LAW

Translated from the German by W.E. Weisflog. By Arnold A. Knechtle. London, HFL (Publisher) Ltd., 1979. 264 pp., £13.50. (hardcover).
Updated version of a doctoral thesis translated into English from the German original, "Grundfragen des internationalen Steuerrechts". Study dealing with obstacles to economic integration, including fiscal obstacles, the concept of international fiscal law, the elimination of international double taxation and the legal sources of international law. (B. 102.094)

### HANDBOOK ON EXPORT FREE ZONES

By Thomas Kelleher. Vienna, United Nations, 1976. United Nations Industrial Development Organization, UNIDO/IOD.31, July 22, 1976. 117 pp.
Study of the development of export free zones in the world. (B. 102.122)

### INTERNATIONAL CONTRACTS CONFERENCE

The 3rd Multi-choice conference held by Seminar Services International, Amsterdam, November 22 and 23, 1979. In two volumes. Lausanne, Seminar Services, 1979. 171 + 273 pp.
Printed working papers distributed for participants in the International Contracts Conference held in Amsterdam, November, 1979. Subjects dealt with are: international adhesion contracts, joint ventures and other forms of doing business in the USSR, protection of crediting, interest in commercial contracts with U.S. firms, international mergers, possible tax liabilities of the seller in the country of the buyer, etc. (B. 102.309)

### INTERNATIONAL CORPORATE PLANNING

By Michael Z. Brooke and Mark van Beusekom. London, Pitman Publishing, Ltd., 1979. 323 pp.
Study on the specific issues involved in international corporate planning covering the nature of international corporate planning, the environment in which it is conducted, the major techniques available to planners and the role of planning departments.
(B. 102.229)

### INTERNATIONAL ECONOMIC DEVELOPMENT AND RESOURCE TRANSFER

Workshop 1978. Edited by Herbert Giersch. Tübingen, J.C.B. Mohr (Paul Siebeck), 1979. 620 pp.
Printed texts of the papers prepared by various contributors for a workshop held in June 1978. The following subjects are included: the relationship between the domestic and international sectors in economic development; problems of measuring the production and absorbtion of technologies in developing countries.
(B. 102.249)

### INTERNATIONAL ENTERPRISES AND TAXATION

Some preliminary results of an empirical study concerning international enterprises. By Sven-Olof Lodin. Stockholm, The Nordic Council for Tax Research, 1979. 26 pp. (B. 102.222)

### INTERNATIONAL TAXATION AND LIVING COSTS 1979

London, Inbucon/AIC Salary Research Unit, 1979. 52 pp.
Information on the personal taxation rates and social security contributions in various countries and the exchange rates, necessary for administration of employees working in those countries.
(B. 102.230)

### INSTITUTE ON MULTINATIONAL TAXATION

Course materials. June 27-29, 1979, Washington. Co-sponsored by the Chamber of Commerce of the United States in cooperation with Marchmont Conferences (London) and The American Tax Institute in Europe (Paris). Washington, Georgetown University Law Center, Continuing Legal Education and the Chamber of Commerce of the United States, 1979.
Loose-leaf publication containing topics contributed by various speakers on multinational tax issues. (B. 102.140)

### INTERNATIONALER TECHNOLOGIETRANSFER UND STEUERRECHT

By Karl-Ludwig Busse. Frankfurt, Verlag Peter Lang, 1978. Studien zum Finanz- und Steuerrecht, Band 2. 331 pp.
This book surveys the influence of taxation on the development of the international transfer of technology between independent and combined enterprises. Taking the tax systems of the German Federal Republic, the United States, France, Austria, Canada, Spain, Brazil and Mexico as examples, the influence of national tax laws and of double taxation treaties on the tax burden of the transfer of technology is illustrated and their impact on business decisions of enterprises is analyzed. (B. 102.084)

### INTERNATIONAL TAX AVOIDANCE

A study by the Rotterdam Institute for Fiscal Studies. Volume A: general and conceptual material. Project leader: Dr. J.C.L. Huiskamp. Principal authors: Dr. Barry Bracewell-Milnes, Mr. M.A. Wisselink. Deventer, Kluwer, 1979. 368 pp., 90 Dfl.
Volume A contains the general and conceptual material and discusses the concept of international tax avoidance, what causes it and how it is achieved, especially through the use of tax havens. Dealt with are attempts to prevent international tax avoidance by various legal measures and their administration, and the international dimension of collaboration between governments.
(B. 102.162)

### MANAGERIAL FINANCE

6th Edition. By J. Fred Weston and Eugene F. Brigham. Eastbourne, Holt-Saunders, Ltd., 1978. 1030 pp.
Revised sixth edition of textbook on managerial finance. Questions and problems are appended for each topic discussed.
(B. 102.226)

### THE MEASUREMENT AND REFORM OF BUDGETARY POLICY

By T.S. Ward and R.R. Neild. London, Heinemann Educational Books, 1978. 118 pp.
Study on measurement and reform of budgetary policy.
(B. 102.261)

### PROCEEDINGS OF A CONFERENCE ON LOCAL GOVERNMENT FINANCE

London, Institute for Fiscal Studies, 1973. Publication No. 10, December 1973. 141 pp., £ 2.
Printed texts of the following talks are included: "The reform of local government finance" by C.D. Foster; "The rising cost of local government services" by Peter M. Jackson and discussions.
(B. 102.262)

### THE STRATEGY OF MULTINATIONAL ENTERPRISE

Organization and finance. Second edition. By Michael Z. Brooke and H. Lee Remmers. London, Pitman Publishing, Ltd., 1978. 277 pp.
Interdisciplinary study on the strategy of the operations of multinational enterprises with emphasis on the structure and control of such companies. Topics such as company-government relationships and strategic considerations on moving abroad are also discussed. (B. 102.228)

### TRANSFER PRICING AND MULTINATIONAL CORPORATIONS: AN OVERVIEW OF CONCEPTS, MECHANISMS AND REGULATIONS

By Sylvain R.F. Plasschaert. Hants, Saxon House, Teakfield Ltd., 1979. 120 pp.
Study on the concept of transfer pricing and guidelines for constructive solutions. (B. 102.130)

### TAX INCENTIVES FOR PRIVATE INVESTMENT IN DEVELOPING COUNTRIES

Editor: Robert Anthoine. Deventer, Kluwer, 1979. 272 pp.
Comparative analysis of the tax laws of developed countries which have a bearing upon direct private investment in developing countries, including tax reports on 19 developed countries prepared by national authors, and eight tax reports on developing countries. (B. 102.161)

### TWENTY-NINTH ANNUAL REPORT ON EXCHANGE RESTRICTIONS 1978

Washington, International Monetary Fund, 1978. 476 pp.
Annual report on global exchange restrictions as well as other measures and intergovernmental arrangements that may have balance of payments implications. The period covered is 1977 and the early part of 1978. (B. 102.176)

### UNITED NATIONS DRAFT MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES

(Unofficial Draft to be considered at its Eighth Meeting in December 1979 by the Group of Experts on Tax Treaties between Developed and Developing Countries). IFA Seminar Paper (Wednesday, September 5, 1979). Deventer, Kluwer, 1979. 30 pp.
Text of the Draft Model Double Taxation Convention between Developed and Developing Countries. (B. 102.173)

YEARBOOK OF NATIONAL ACCOUNTS STATISTICS 1978

2 Volumes. New York, United Nations, 1979. 1494 + 645 pp. Twenty-second issue of the Yearbook of National Accounts Statistics prepared by the Statistical Office of the United Nations. Volume I, "Individual country data", shows detailed national accounts estimates for 151 countries and areas. Volume II, "International tables", contains other information, estimates of total and per capita gross domestic product, national income, and national disposable income expressed in U.S. dollars for 155 countries and areas. (B. 102.281)

## IRELAND

FIFTY—FIFTH ANNUAL REPORT OF THE REVENUE COMMISSIONERS

Year ended 31st December 1977. Dublin, Stationery Office, 1978. 163 pp. (B. 102.214)

OECD ECONOMIC SURVEYS: IRELAND

Paris, Organisation for Economic Co-operation and Development, 1979. 56 pp., 12 Fr.Frs. (B. 102.133)

## ITALY

CODICE TRIBUTARIO

Seconda edizione. Milan, Dott. A. Giuffrè Editore, 1978. 2698 pp.
Compilation of Italian tax laws and decrees. (B. 102.286)

CODICE TRIBUTARIO

Seconda edizione. Appendice. Milan, Dott. A. Giuffrè Editore, 1979. 648 pp.
Appendix to the compilation of tax laws, which updates the basic volume to January 31, 1979, and with respect to the VAT, to April 1, 1979. (B. 102.287)

COMPANY INCOME TAX IN ITALY

With taxation on dividends, interest, royalties and other forms of income. Rome, Banco di Roma, 1979. 92 pp. (B. 102.101)

LA DETERMINAZIONE DEL REDDITO IMPONIBILE NEI RAPPORTI FRA SOCIETA ITALIANE E COLLEGATE ALL'ESTERO

Società per lo studio dei problemi fiscali, Convegno di Rapallo, 29-30 giugno 1979. By Augusto Fantozzi. Genova, Diritto e Practica Tributaria, 1979. 20 pp.
Paper on the determination of profits of Italian companies and related foreign companies. (B. 102.184/189)

MANUALE DELLE IMPOSTE DIRETTE

3 Volumes. By Giuseppe Giuliani. Milan, Casa Editrice Giuffrè, 1979. 3781 pp.
Handbook of direct taxes, compilation of tax laws and degrees, administrative rulings and letters and case laws. This three-volume book is up to date as of June 30, 1979. (B. 102.288)

IL NUOVISSIMO CODICE TRIBUTARIO FISCALE

Annotato per articolo. Edited by Giovanni de Riso, Mario Spina and Francesco Dibari. Piacenza, Casa Editrice La Tribuna, 1979. 1436 pp.
1979 Edition of compilation of tax laws, decrees and annotations. (B. 102.102)

DAS SCHWEIZERISCH-ITALIENISCHE DOPPEL-BESTEUERUNGSABKOMMEN

La Convenzione tra Svizzera e Italia sulle doppie imposizioni. The Swiss-Italian double taxation convention. By Silvio Bianchi and Siegfried Mayr. Bern, Editions Cosmos, 1979. 82 pp.
Handbook published in German, Italian and English, explaining the comprehensive double taxation treaty between Italy and Switzerland signed April 28, 1978 as viewed from the Swiss and Italian points of view. (B. 102.129)

## JAPAN

OECD ECONOMIC SURVEYS: JAPAN

Paris, Organisation for Economic Co-operation and Development, 1979. 63 pp., 12 Fr.Frs. (B. 102.134)

AN OUTLINE OF JAPANESE TAX ADMINISTRATION 1979

Tokyo, National Tax Administration, 1979. 89 pp. Guide providing an outline of the tax administration in Japan. Activities of the National Tax Administration are described. (B. 51.441)

AN OUTLINE OF JAPANESE TAXES 1979

Tokyo, Tax Bureau, Ministry of Finance, 1979. 295 pp.
Annual guide explaining the taxes in Japan updated to include the 1979 tax changes. (B. 51.440)

## LUXEMBOURG

LES SOCIETES HOLDING AU GRAND-DUCHE DE LUXEMBOURG

Aspects juridique, fiscal et comptable. Luxembourg, Institut Universitaire International Luxembourg, 1979. 150 pp.
Study on the concept of holding companies under Luxembourg tax law and its future developments in the light of the European Communities policy. Relevant text of statutes is appended.
(B. 102.095)

## MALAYSIA

THE 1980 BUDGET SPEECH

By the Minister of Finance in the House of Representatives on October 18, 1979. Kuala Lumpur, Government Printer, 1979. 53 pp. (L. 52.186)

## MEXICO

CONSIDERACIONES ACERCA DE LA DOBLE TRIBUTACION INTERNACIONAL

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A set of brochures providing facts about doing business in the Netherlands covering the following subject: How Duch tax law affects the U.S. investor; Business entities and company law in the Netherlands; Labor relations in the Netherlands; Trading in the Netherlands; Banking, finance and government incentives in the Netherlands; Taxation, accounting and auditing in the Netherlands; The Netherlands (introduction). (B. 102.263)

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Explanation of the taxation of companies in New Caledonia. In addition it treats business tax, tax on financial activities and other related taxes levied on the establishment of a company. Text of statutes is appended. (B. 51.425)

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Booklet on New Zealand in the series of Investment Incentives and Taxation, prepared by Touche Ross International, dealing with general investment law and taxation. (B. 51.397)

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### INTERNATIONELLA FÖRETAGS BESKATTNING

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Research report prepared by the Nordic Research Council of Tax Science with respect to taxation of international enterprises with emphasis on the performance by Nordic countries. Researchers from Denmark, Norway, Sweden and Finland participated in the study headed by Prof. Sven-Olof Lodin. (B. 102.222)

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Consolidated plain text of the legislation on capital transfer tax, development land tax, stamp duty and value added tax. (B. 102.282)

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### CAPITAL TRANSFER TAX

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Monograph on capital transfer tax. Text of statutes is appended. (B. 102.269)

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Second revised edition of guide intended to be a comprehensive exposition of capital transfer tax law for practitioners as well as students. The law is stated as of November 1, 1977. (B. 102.071)

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Fourth revised edition, giving an exposition of the law as of August 1, 1978. (B. 102.072)

### DISCLOSURE TO UNIONS – HOW THE LAW IS WORKING

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By A.B. Atkinson and A.J. Harrison. Cambridge, Cambridge University Press, 1978. 330 pp.
Study examining the distribution of personal wealth in Britain and analysing the underlying social and economic forces. Statistical and economic background information to current debates on justice and the taxation of wealth is provided. (B. 102.090)

### DOUBLE TAXATION RELIEF

London, Her Majesty's Stationery Office, 1979. 33 pp.
Booklet explaining the main features of the law and practice relating to double taxation relief for taxes on income and capital gains, including the double taxation agreements which the U.K. has made with other countries. (B. 102.074)

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### THE HAMBRO TAX GUIDE 1979-80

By A.S. Silke and W.I. Sinclair. London, MacDonald and Jane's Publishers, Ltd., 1979. 257 pp., £ 5.95.
This eighth edition updates the general tax guide incorporating the material as of August 1, 1979 including the Finance Act 1979 and Finance (No. 2) Act 1979. (B. 102.202)

### KEY TO INCOME TAX

Finance (No. 2) Act 1979 edition. By J.M. Cooper. London, Taxation Publishing Company, 1979. 256 pp., £ 5.50.
Annual reference guide providing information on the income tax as amended by Finance (No. 2) Act 1979 of September 1, 1979. (B. 102.304)

### LAW FOR THE RETAILER AND DISTRIBUTOR

Third edition. By J.R. Lewis. Bristol, Jordan & Sons, Ltd., 1979. 220 pp., £ 6.50.
Considerations on the laws affecting the retailer and distributor. Relevant texts of statutes are appended. (B. 102.259)

### PROFIT SHARING AND OTHER SHARE ACQUISITION SCHEMES

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Second edition. Editor: Nigel Eastaway with David Trill. London, Butterworths, 1979. 576 pp.
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Second edition. By Richard Bramwell and John Dick. London, Sweet & Maxwell, 1979. 236 pp., £ 17.
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### TAX EXPENDITURES IN THE UNITED KINGDOM

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The book deals with various exemptions and reliefs from income tax in the U.K. which reduce the tax base and in effect discriminate in favour of particular personal circumstances and particular kinds of income and expenditure. (B. 102.260)

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Third cumulative supplement. Up to date to March 1, 1979. By Terence Mowschenson. London, Sweet & Maxwell; Edinburgh, W. Green & Son, 1979. 116 pp.
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## COMPREHENSIVE INCOME TAXATION

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Publication of the papers of a conference held by scholars and government officials on the fundamentals of comprehensive income taxation. The authors cover such issues as the economic definitions of income, personal deductions, employee benefits and transfer payments, capital gains and losses, the tax treatment of the family and taxable business income. (B. 102.089)

## 1979 DEPRECIATION GUIDE

Including ADR system; system for pre-1971 assets. Chicago, Commerce Clearing House, Inc., 1979. 263 pp., $ 7. (B. 102.124)

## FACTS AND FIGURES ON GOVERNMENT FINANCE

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Second edition. By John K. McNulty. St. Paul, Minn. West Publishing, Co., 1979. 488 pp.
Introduction to the law of federal estate and gift taxation. (B. 102.125)

## FEDERAL INCOME TAXATION

Volume one: taxation of individuals. Third edition. By Adrian A. Kragen and John K. McNulty. St. Paul, Minn., West Publishing Co., 1979. 1283 pp.
Completely revised third edition of the Kragen & McNulty income tax casebook which contains only material dealing with the income taxation of individuals. A second volume will contain the material on the taxation of corporations and partnerships. (B. 102.204)

## FEDERAL INCOME TAXATION/CASES AND MATERIALS

Volume I. By Stanley S. Surrey, William C. Warren, Paul R. McDaniel and Hugh J. Ault. Mineola, N.Y., The Foundation Press, Inc., 1972. 1419 pp.
Volume I contains provisions affecting both individuals and corporate taxpayers with emphasis on taxation of individuals. Volume II will cover the taxation of business organizations. This volume is a companion volume to Warren & Surrey, "Federal Estate and Gift Taxes, Cases and Materials". (B. 102.254)

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## FOREIGN TRADE TAX HANDBOOK FOR MANUFACTURERS

How to use a DISC and other forms of corporations to export and to operate abroad more profitably. By Paul D. Seghers. New York, International Tax Institute, Inc., 1979. 171 pp. (B. 102.223)

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Chicago, Commerce Clearing House, Inc., 1979. 450 pp., $ 7.
Reprint from the Commerce Clearing House Pension Plan Guide dealing with the rules and authorities on pensions, profit sharing and employee benefits. (B. 102.285)

## HAWAII INCOME PATTERNS 1976: INDIVIDUALS

Honolulu, Tax Research and Planning Office, Department of Taxation, 1979. 79 pp.
This nineteeth annual report summarizes individual income tax statistics from a sample of 1976 Hawaii individual income tax returns. (B. 102.183)

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## THE INDIRECT CREDIT

A study of various foreign tax credits granted to domestic shareholders under U.S. income tax law. Volume II. By Elisabeth A. Owens and Gerald T. Ball. Cambridge, International Tax Program, Harvard Law School, 1979. 386 pp.
Second volume of study describing and analysing the U.S. law governing the credit granted to domestic corporations for foreign income taxes paid by foreign corporations. The law and case law is stated as of November 1, 1978. (B. 102.303)

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By John A. Brittain. Washington, The Brookings Institution, 1978. 102 pp.
Study which draws attention to the inequality in the distribution of wealth rather than to the inequality in the distribution of income. The role of material inheritance in the perpetuation of inequality of wealth is evaluated. (B. 102.093)

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Monograph describing the tax aspects arising from investment in real estate in the U.S.A. by individuals and by companies resident in the Netherlands. Relevant statutes are appended. (B. 102.224)

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As of October 1, 1979. Chicago, Commerce Clearing House, Inc., 1979. 672 pp., $ 8.50.
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A compendium of studies prepared for the U.S. Congress by the Congressional Research Service, Library of Congress. The articles include: "Tax fraud: distinguishing civil and criminal tax frauds" by Howard Zaritsky; "Outline of major changes in the social security cash benefits program under Title II of the Social Security Act" by Joel Greenberg. (B. 102.091)

### U.S. TAXATION OF AMERICAN BUSINESS ABROAD

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The book gives information for the following groups of taxpayers: corporate executives, professional persons and sales persons. It contains individual tables of contents and topical indexes for each special taxpayer classification. (B. 102.240)

### TAX PLANNING 1980

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Principal paper by Norman B. Ture. Edited by Arleen A. Leibowitz. Toronto, Lexington Books, 1978. 130 pp.
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Summary of Singapore's 1980 Budget
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The tax system of Kiribati

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# CONFERENCE DIARY

## MAY 1980

*Nederlandse Federatie van Belastingconsulenten:* Belastingconsulentendag 1980 (Tax consultants' day 1980) (including: What does double taxation in fact mean?), The Hague (The Netherlands), May 2 (Dutch).

*Institute for International Research:* The 1980 Company Secretaries' Conference (including: Taxation and tax planning), London (United Kingdom), May 1 and 2 (English).

*Anglo—U.S. branches of I.F.A.:* Seminar (including: U.K./U.S. treaty, unitary taxation, new legislative developments, interpretation of statutes and ruling procedures), New York (U.S.A.), May 8 and 9 (English).

*U.S. branch of I.F.A.:* Technical Session (Subject not yet known), New York (U.S.A.), May 10 (English).

*Seminar Services International:* International Conference on Managing Foreign Exchange Risk (including: Tax aspects of foreign currency gains and losses), Copenhagen (Denmark), May 8 and 9 (English).

*Institute for International Research:* The 1980 International Corporate Finance Conference (including: Tax considerations in inter-company transactions), Zurich (Switzerland), May 12-14 (English).

*International Association of Assessing Officers:* Fifth International Symposium on Property Tax, Amsterdam (The Netherlands), May 7-10; Paris (France), May 11-15 (English).

*International Tax Planning Association:* The Cannes Tax Conference (including: Exchange of information under tax treaties), Cannes (France), May 28-30 (English).

## JUNE 1980

*Business International Institute:* The Seminar on International Finance (including: Taxation of exchange gains and losses), Port Chester, New York (U.S.A.), June 9-12 (English).

*Georgetown University Law Center* and *The Chamber of Commerce of the United States:* Institute on multinational taxation (treaty problems anti-avoidance measures, use of computers in international taxation, currency gains and losses, international insurance transactions, Brazilian taxation), Washington D.C. (U.S.A.), June 11-13, 1980 (English).

*Inter-American Center of Tax Administration (CIAT):* Fundamental Tax Audit Comsiderations (including: Components of an audit program, organization of a tax audit department, EDP and tax audit, resource management support, legal aspects of tax audit), Washington (U.S.A.), June 22-27 (English, Spanish).

## JULY 1980

*Management Centre Europe:* The China Briefing (including: Tax aspects of doing business in China), Brussels (Belgium), July 3-4 (English).

*Management Centre Europe:* Managing and Developing Foreign Subsidiaries Seminar (including: Tax in international operations), Brussels (Belgium), July 2-4 (English).

*Management Centre Europe:* International Tax Management Seminar (including: Anti-tax haven legislation, tax treatment on technology import and technology export, handling of disputes between tax administrations), Brussels (Belgium), July 10-11 (English).

## AUGUST 1980

*Management Centre Europe:* International Cash Management Seminar (including: International tax aspects in cash management), Brussels (Belgium), August 20-22 (English).

## SEPTEMBER 1980

*34th Annual Congress of I.F.A.:* I. The dialogue between the tax administration and taxpayer up to the filing of the tax return; II. The determination of the source of income. For the seminar the subject is the flight to tax havens, their use and abuse, Paris (France), September 14-19 (English, French, German, Spanish).

## NOVEMBER 1980

*Confédération Fiscale Européenne (C.F.E.):* Second Congress of European Tax Consultants (subject: "La pratique de la Fiscalité en Europe"), Rome (Italy), November 6 and 7 (English, French, German).

FOR FURTHER INFORMATION PLEASE WRITE TO:

Business International Institute, 12-14 chemin Rieu, 1211 Geneva 17 (Switzerland).

CIAT: P.O. Box 2129, Panamá 9A (Panama).

Confédération Fiscale Européenne, Secrétariat Général (C.F.E.), D-5300 Bonn 1, Dechenstrasse 14, German Federal Republic or Siège Social F-75009 Paris, 9 rue Richepanse (France).

Institute for International Research, 70 Warren Street, London, W1P 5PA (United Kingdom).

Investment and Property Studies Ltd., Norwich House, Norwich Street, London EC4A 1AB, United Kingdom (Registration for the Cannes Tax Conference should apply to this address).

International Association of Assessing Officers, 60th Street, 60637 Chicago 1313 East, U.S.A.

International Fiscal Association (I.F.A.): General Secretariat, Woudenstein, Burgemeester Oudlaan 50, P.O. Box 1738, 300 DR Rotterdam (Netherlands).

Nederlandse Federatie van Belastingconsulenten, Wassenaarseweg 20, 2596 CH Den Haag (Netherlands).

Management Centre Europe, Avenue des Arts 4, B-1040 Brussels (Belgium).

Seminar Services International Ltd., Temple Bar House, 23 Fleet St., GB — London EC 4 (United Kingdom).

U.S.A. Branch of I.F.A., 1301 Avenue of the Americas (suite 3400), New York, N.Y. 10019 (U.S.A.).

Georgetown University Law Center, Office of Continuing Legal Education, 600 New Jersey Ave., N.W., Washington D.C. 20001 (U.S.A.).

# Singapore's Tax System

## Past and Present*

by GOH CHOK TONG

**Goh Chok Tong**

Minister for Trade and Industry

*Born in Singapore in 1941. Educated at Raffles Institution and graduated in 1964 from the University of Singapore with a B.A. (Hons.) Class I in Economics. In 1966, was awarded a Fellowship to Williams College, U.S.A., where he obtained his Master of Arts in Development Economics.*

*Joined the Singapore Administrative Service in 1964. Worked as economic planner and research economist. In August 1969, was seconded to the newly-incorporated Neptune Orient Lines Ltd. (NOL), Singapore's national shipping line, as its Planning and Projects Manager. Resigned from the Civil Service to become a permanent staff of NOL about a year later. Appointed as Financial Controller and later Financial Director on Board of NOL. Became the Company's Managing Director in November 1973. Left in 1977 to take up appointment as Senior Minister of State.*

*Has served as Chairman of the National Statistical Commission and NTUC INCOME, and Board Member of Port of Singapore Authority, Post Office Savings Bank, Sembawang Shipyard Ltd., Container Warehousing & Transportation (Pte) Ltd., and various subsidiary and associate companies of NOL.*

*Is Deputy Chairman of Singapore Labour Foundation and Board Member of People's Association. Governor of Asian Development Bank.*

*Elected Member of Parliament for the Marine Parade constituency in the 1976 General Elections. Appointed Senior Minister of State for Finance in September 1977, and Minister for Trade and Industry in March 1979.*

We are indeed honoured that you have chosen to hold your 6th International Tax Conference in Singapore for a second time. Your Third Conference was held here in 1974 and to those of you who have been here before, I hope you will find the changes and development in Singapore interesting enough to justify your coming back. May I welcome you back as well as all other participants and guests who are here for the first time.

I am, however, constrained by your eminent presence to sally forth on a subject in which you are clearly superior. There is another constraint. With the Singapore Government Budget Statement due to be delivered only a month from now, any provocative statement on taxes will unwisely take the wind out of the Budget sail. Thus, I find it prudent on my part to limit myself this morning to a brief historical description of Singapore's tax system, concluding with some remarks on the lessons that can be abstracted from our experience.

Traditionally, Singapore's economy has been dependent on entrepot trade. Industries were limited to those which could take advantage of Singapore's geographical location, such as processing industries of commodities produced in the region. The dependence on entrepot trade required the pursuit of a free port policy. This greatly narrowed the scope for raising public revenue. Unlike many countries, Singapore could not depend on extensive import and export duties. Income tax was considered undesirable and impractical because of the certainty of evasion, but the Colonial Government probably also had little incentive to tax their own wealthier and more influential expatriate population. Thus, before World War II, the main source of revenue was a tax on the consumption of liquors, pork and fish, gaming tables and pawnbrokers' shops, and a bizarre tax on opium consumption. Opium farms were created and the widespread addiction of the local population to opium provided the British Administration with an easy source of revenue. Today, the tax on all these items has been removed except for liquors on which there is a customs revenue duty. Opium consumption, of course, is illegal, and drug addiction is a tax on our resources and not the other way round.

War tax, which was a form of tax on income, was introduced for the first time in 1917 as a temporary expedience to provide funds for the war effort. An attempt was made to make it a permanent tax after the war, but it failed because of strong opposition. During the last year of the operation of the tax in 1922, $3.9 million was collected constituting about 10 percent of the total Government revenue. In 1941, tax on income was reintroduced to meet the war commitments but before much revenue could be collected, Singapore fell to the invading Japanese forces.

* Speech at the opening of the 6th International Tax Conference in Singapore on 4 February 1980.

After the Second World War, huge sums were required to reconstruct Singapore. The need to explore new sources of revenue became even more acute when the smoking of opium was prohibited following public and social pressures. It was not without vocal resistance that tax on income was legislated in 1947. Since then, income tax has assumed prominence, and, today, it is the mainstay of Government revenue contributing $1.28 billion, or 35 percent of Government revenue.

Other taxes, although introduced earlier, were not that eventful or as bizarre as the opium tax. Estate duty was introduced in 1885, and stamp duty, levied on various kinds of commercial and local documents, in 1896. Property tax, which is a tax on the annual value of real property, was levied only in 1960. Prior to that, the City Council and the Rural Board levied local assessments on rates.

During the 1960s, Singapore embarked on planned industrialization to solve the main economic problems of the day — slow economic growth and high unemployment. Industrialization was spearheaded by import-substitution industries, and protective duties were introduced. But it did not take long for Singapore to realise that its future lay in export-oriented industries and not inward-looking domestic industries. Protective duties ceased to be introduced for new industries, and, today, the question is when and not whether to remove the vestiges of protective duties introduced in the early days to induce industries to be set up.

In the 1970s, Singapore strove to be a financial centre. Tax measures were used to facilitate this. In 1969, legislation was passed to exempt from tax interest derived by non-residents on deposits with banks. In 1973, the tax for certain offshore income derived by Asian Currency Units of financial institutions was reduced to 10 percent. The concession was subsequently extended to cover other offshore income such as income derived from financing or re-financing of offshore trade transactions and foreign exchange transactions in currencies other than Singapore dollars with persons outside Singapore.

Singapore's Income Tax Act is basically simple. This simplicity has been maintained over the years despite amendments made from time to time. The amendments were necessitated by economic and social considerations.

Tax concessions, however, are contained in separate legislation. The Pioneer Industries (Relief from Income Tax) Ordinance was introduced in 1959 to provide tax holidays of up to five years to pioneer enterprises and tax concessions to firms for income attributable to expansion in capital investments. In 1967, the Economic Expansion Incentives (Relief from Income Tax) Act was passed to replace the earlier legislation and to consolidate the laws. The Act will continue to be the framework upon which new tax incentives will be considered.

In the field of property tax, incentive was also employed to stimulate and assist private participation in the redevelopment of the urban area. There was a multiplicity of property tax rates, but the base rate from which reductions are given was 36 percent. For approved projects in the urban area, the rate was reduced from 36 percent to 12 percent for a period of 20 years. This incentive was also extended to developments in Sentosa Island, our tourist resort island. The present multiplicity of rates, however, will be standardized at a single rate of 23 percent by 1983. The objective of a lower standard rate is to achieve a steady growth of the property sector and an improvement in the built-up environment, particularly in the urban area.

The development of Singapore's tax system has been closely tied to the economic and social policies of Singapore. In the last two decades especially, the tax system has been used to promote economic growth, in particular, the growth of the manufacturing and financial sectors. This, in turn, has led to a larger base for income tax and taxes on property and payroll. Consequently, these taxes registered substantial increases and they have now supplanted import and excise duties as the more important revenue items. This leads us to the first theorem on taxes and that is "Less is More". The mathematical expression of this is that 40 percent of zero is zero, 40 percent being the Singapore income tax rate on

*During the first week of February 1980 Singapore hosted the Sixth International Tax Conference. This Conference is the most recent in a series of conferences which started in 1970 at the initiative of Professor G.S.A. Wheatcroft and which have been held every two years (1970 — Nassau, Bahamas; 1972 — Kingston, Jamaica; 1974 — Singapore; 1976 — Nairobi, Kenya; 1978 — Honolulu, Hawaii, U.S.A). A large percentage of the speakers and the participants attended several if not all of the conferences, a feature which creates an almost ideal framework for discussing new developments in international taxation, particularly in regard to the countries and territories of the British Commonwealth. At each conference, ample attention is given to taxation in the region where it is held.*

*The opening address of the Sixth International Tax Conference was given by the Minister for Trade and Industry, Mr. Goh Chok Tong, whose statements are likely to surprise those who are used to the almost general call for higher income taxes in other parts of the world.*

*Minister Goh's address was followed by a talk by Mr. Wong Pakshong, managing director of the Monetary Authority of Singapore.*

*It is with much pleasure that we publish the text of both addresses with the permission of the two speakers. In addition, an extract from the Budget Speech 1980 is included in this issue.*

*Further details of the tax system of Singapore (as well as of the other countries in South East Asia) are contained in the 6-volume loose-leaf work* Taxes and Investment in Asia and the Pacific, *prepared and published by the Bureau.*

corporation profits. Thus, conditions must be created for investments to take place, and for these investments to succeed.

As Singapore now enters its second stage of industrial development with emphasis on higher technology industries, tax incentives will play an important role in attracting investment and transfer of technological know-how. But more important than the tax system is the political and economic climate for investment. There must be political stability to ensure the security of investments. There must be discipline amongst workers and management and affable industrial relations. The private sector must be given maximum leeway to exercise its ingenuity, innovativeness and risk-taking capability. If these basic political and economic parameters are present, less tax in an expanding economy will lead to more revenue.

Work and investments are ingredients vital to Singapore's continued growth and prosperity. The income tax structure must never discourage this.

Thus, taxes must descend to the minimum level of Government expenditure consistent with good administration and not expenditure rising to the maximum taxes possible. This I offer as the second principle of taxation. There must therefore be periodical reviews of the entire gamut of taxes. Taxes which have outlived their original objectives should be scrapped even though they are convenient sources of revenue. Personal income tax rates must be periodically revised to take into account the pernicious effect of inflation. An overtaxed society which consistently yields more revenue than the expenditure required could lead to inefficient uses of public funds.

Taxes are never popular, particularly, personal income tax. In levying them, it is worth our remembering the third dictum: The more heavily a person is supposed to be taxed, the greater his incentive to escape being taxed. And if he thinks he can cheat safely, he probably will. There must, therefore, be adequate anti-avoidance and anti-evasion provisions in the Tax Act, and an effective machinery to back up these provisions. It is accepted that tax avoidance is within the law. However, artificial ways of transacting business such as the creation of "shell" companies to avoid paying tax altogether must be discouraged. Sometimes such tax avoidance manipulations slip into the area of tax evasion. Thus, the process of preventing serious loss of revenue will continue and be intensified, if necessary. But, of course, we should not tax a person too heavily.

As a government must spread the benefits of its expenditure amongst the population, the tax net must cover as many people as possible, but consistent with their ability to pay. The more taxpayers there are, the lower the tax per capita. Our fourth principle of taxation is: spread benefits and taxes amongst the population. Equity requires taxes to be levied for the benefit of the taxed.

And lastly, let me quote you the eternity law: Nothing is certain except death and taxes.

# The Future Position of Singapore in International Taxation*

by Michael Wong Pakshong **

Michael Wong Pakshong

*Mr. Michael Wong Pakshong currently holds the post of Managing Director of the Monetary Authority of Singapore.*

*He was born June 2, 1931 in Durban, South Africa where he graduated from High School in 1949. He further acquired a B.A. (Hons) at the University of Bristol (United Kingdom) and became a Fellow of the Institute of Chartered Accountants in England and Wales in 1959.*

*Other appointments held by Mr. Wong are: Chairman of the Neptune Orient Lines Limited, Chairman of the Securities Industry Council, Deputy Chairman of the Board of Commissioners of Currency of Singapore and Governor of the International Monetary Fund.*

It was with some diffidence and apprehension that I agreed to speak at this conference. I would be the first to admit that I am not a tax expert. What little tax I learned as an articled clerk in London over 20 years ago has long since been forgotten. Another reason is the sneaking suspicion that the title of the address was foisted on me in the expectation that there might be a preview of tax changes to come. Alas, I fear I shall disappoint you.

My only exposure to tax — apart from the common affliction we all suffer as taxpayers — are the frequent pleas and representations why additional areas of banking and financial activities should be either exempted from tax completely or the rates reduced even further. Of course there are those who do not make a frontal assault by calling for the abolition of a tax — but rather deviously try to advocate a zero rate of tax. I

* Address given at the opening session of the Sixth International Tax Conference held from 4th to 8th February 1980 in Singapore.

** Managing Director of the Monetary Authority of Singapore.

suppose there is a fine distinction between the abolition of a tax as opposed to a zero rate of tax, but I suppose it is best to leave this philosophical point for further discussion by all the experts we have assembled here today.

## SINGAPORE IS NOT A TAX HAVEN

It has never been said of Singapore that it is a tax haven. The standard rate of tax on corporate profits is 40 percent, while the highest marginal rate of personal tax is 55 percent. For an individual resident in Singapore the income tax rates are as follows:

| *Chargeable income* | *$* | *Rate of tax (%)* |
|---|---|---|
| first | 2,500 | 5 |
| next | 2,500 | 8 |
| next | 2,500 | 10 |
| next | 2,500 | 12 |
| next | 5,000 | 15 |
| next | 5,000 | 20 |
| next | 5,000 | 25 |
| next | 10,000 | 30 |
| next | 15,000 | 35 |
| next | 50,000 | 40 |
| next | 100,000 | 45 |
| next | 200,000 | 50 |
| income exceeding | 400,000 | 55 |

Furthermore, we have as diligent and conscientious an Anti-Evasion Unit of the Inland Revenue as can be found anywhere in the world.

While there are sections of the population who escape the tax net, those of us who are privileged to pay tax can vouch for the efficacy of the collection system.

This leads me to make on prediction about the future position of Singapore in international taxation. Perhaps it is the only prediction that I feel confident of making. It is only a matter of time before the system is improved to bring within the tax net the many self-employed persons who have hitherto avoided paying tax.

Although Singapore is not a tax haven certain transactions do not attract tax. Perhaps the most obvious is that we do not have a capital gains tax. As long as anyone does not make a trade or profession in dealing, profits from buying and selling securities, for example, it can be freely carried out.

Most observers agree that there are no signs that a capital gains tax is likely to be introduced. This of course means that a number of investment companies have tried to find ways to buy and sell shares and yet escape tax — especially when there is an increasing frequency of profitable transactions. It is perfectly understandable why portfolio managers would like clearcut definitions/guidelines laid down so that they can then tailor all transactions to fall neatly as capital gains. I very much doubt if we can achieve such definitions or guidelines which the Inland Revenue authorities will readily accept.

A few years ago, when world interest rates were much lower, there existed a perfectly legal way for individuals to earn a very reasonable rate of return by opening a savings account with the Post Office Savings Bank. What was remarkable was that the interest earned from a Post Office Savings Account was not subject to tax and there was no ceiling to the amount of interest which any individual could derive from this source. The limitation was set only by the wealth of individuals.

During the period 1968 to 1978 the Post Office paid an interest rate of 5 percent p.a. — which meant that anyone with a marginal rate of 55 percent enjoyed an equivalent grossed up rate of 11 percent. But alas, all good things come to an end. Nowadays only the interest earned on a maximum deposit of $100,000 is exempt from tax — (which when grossed up at a marginal rate of 55 percent and an interest rate of 6 percent gives a grossed up rate of 13.3 percent). Deposits in excess of $100,000 are exempt from tax — but the Post Office Savings Bank only pays 4¼ percent — which gives a grossed up rate of 9.4 percent — which is hardly attractive these days.

For the non-resident of Singapore there are other attractions in making deposits with banks in Singapore. A non-resident does not have to pay tax on interest from deposits made with banks in Singapore. He also has the additional exemption from estate duty which is conferred on Asian dollar accounts.

## STAMP DUTIES

Apart from income tax, we have in Singapore — as do many countries who are members of the Commonwealth — a comprehensive range of stamp duties. This is an arcane area of revenue law where many fear to tread. There were stamp duties in Singapore long before anyone thought of bringing in income tax. Like a good member of the Commonwealth, Singapore has preserved intact the stamp duties which have remained practically unchanged since 1929. Such amendments as were made were mainly concerned with increasing revenue from stamp duties.

In the 1970's, as the nature of banking became more sophisticated, it became apparent that stamp duties — especially those levied on an ad valorem basis — would inhibit the development and growth of banking and financial activities. The banking lobby was most persuasive in getting the many stamp duty amendments which were made from 1972 onwards. They rightly pointed out that the yields from the offending stamp duties were minimal, whereas the exemption from duty at least creates a market and results in transactions whose profits would be subject to Singapore tax. This coincided at the time with the government's objective to promote the Asia Dollar Market. The market in Asian dollar bonds, negotiable certificates of deposits, promissory notes, bills of exchange and loan syndicates could not have been established if the stamp duty exemptions had not been given.

## THE CHARACTER OF TAX INCENTIVES IN SINGAPORE

The study of Singapore's tax incentives in the past 20 years will be a fruitful area of study for the economic historian. Any study will show how the introduction of these incentives has been used to shape and influence not only the rate of growth — but also the direction in which economic activity was positively directed.

In the 1960's, there was unemployment and an over-reliance on entrepot trade and related activities. The policy then was to diversify the economy and to promote labour-intensive industries. It was also aimed at import substitution. To achieve this an effort was made to attract foreign investments. Thus from 1959 onwards a range of tax incentives was introduced which basically gave investors tax holidays — or pioneer status as they are called in Singapore.

As foreign investors set up plants, so the incentives were widened to encourage non-pioneer industries to invest in up-to-date capital equipment. They were allowed the benefit of accelerated depreciation (Income Tax (Amendment) Act 1965).

Incentives have evolved over the years and there is no longer the emphasis on import substitution or the promotion of labour intensive industries.

However, it is the Economic Expansion Incentives (Amendment) Acts of 1975 and 1979 which are interesting. Even without any minimum capital investment pioneer status was extended to any enterprise which places a premium on skill and craftsmanship as well as producing a product where the value added was high. It also allowed local and foreign companies to expand their operations into services. Thus we now promote the use of Singapore as a regional warehousing and service centre. Reduced rates of taxation are given to technical and consultancy services performed overseas as well as trading in non-traditional commodities in offshore markets. [1]

The change in direction now recognises the necessity to introduce higher technological levels in manufacturing and the production of more sophisticated manufactured goods — as well as the realisation that greater productivity must be achieved by all sectors of the economy. It is with anticipation that we await the next budget to see if further incentives or disincentives are in store for us.

I must not omit to mention that with the establishment of the Singapore Registry of Shipping tax exemption is given to ships which fly the Singapore flag.

## BANKING AND FINANCE

In modifying stamp duty and income tax, the fiscal climate improved to such an extent that banks and financial institutions found Singapore was a strategic place to have a branch. The recognition of Singapore as a financial centre is evidence of the success of these incentives — though it would be wrong to attribute this success to tax alone.

It is my impression that we now have a system which does not require much more tinkering around with, certainly as far as fiscal incentives are concerned. Of course, there are eternal optimists who continue to advocate a zero tax rate for all offshore activity.

It seems to me that the economic growth that we have had over the last ten years in the region has not gone unnoticed. For many of the institutions, it is the desire to participate in what they perceive to be the potential opportunities for profit which draws the banks here rather than for reasons of tax. By our willingness to allow reputable financial institutions to establish offices here, we continue to receive applications and enquiries.

This is not to say that we can afford to be complacent. Far from it. There are still areas in our income tax and revenue laws which can do with some streamlining and rationalisation. Such changes as may occur will be relatively minor, certainly as far as banking is concerned. I expect that it is not so much tax changes that banks would like to see — but rather changes in the ground rules we have established for their operations. This, of course, is a controversial area which should be discussed — but in another forum.

As far as I am aware there is no measure we can take which could lead to a quantum leap similar to that which occurred when withholding tax on bank interest was abolished over 10 years ago. No measure, that is, apart from the total abolition of income tax or a drastic reduction in tax rates.

So far I have tried to describe the features of our tax system — how it has made Singapore what it is today in terms of economic strategy and development.

1. There is an effective system of taxation so that there is no question of Singapore qualifying as a tax haven.
2. Despite not being a tax haven there are a limited number of ways of conducting transactions which are not subject to tax — outside of outright tax evasion.
3. *Stamp duties*
   I described modifications and amendments which were necessary to give us an even chance of promoting banking and finance.
4. *Tax incentives*
   How incentives have evolved over the years and the growing refinement in changing the character of industrialisation.
5. *Banking and finance*
   I expressed the view that we have probably made most of the changes necessary for this sector.

All this has been enumerated to provide a perspective of where we are — and in view of what we have done — where we are likely to go.

Some guideposts of the highways and byeways we are likely to traverse may be gleaned from government statements.

1. *Editor's note:* See for privileged treatment accorded with respect to warehousing and servicing incentives and consultancy services Lee Fook Hong, *Singapore's new tax incentives* in 33 BULLETIN FOR INTERNATIONAL FISCAL DOCUMENTATION 386, 388 (1979).

## POSITIVE FISCAL POLICY

In the 1978 Budget, taxpayers in Singapore were given a pleasant surprise when taxes were reduced by raising the ceilings before the top marginal rate of 55 percent became effective.[2] I would like to quote what was said by the Minister of Finance when he introduced the change:

*"Aggravating the problem of equity or fairness in sharing the tax burden is the ability of many self-employed and professionals to incorporate themselves into companies in order to sell their personal services, and thereby quite legally avoid paying tax at more than 40 percent, the company rate. Professionals and executives working for the public sector on salaries are unable to take advantage of this loophole in the law. Nor do they enjoy the perks of tax-free 'expenses'.*

*I have therefore decided, from Year of Assessment 1978, to make income tax less inequitable by broadening the steps over which the tax rate goes up".*

In the same budget, the Minister also stated that it was the policy to shift gradually the impact of taxation from income to consumption taxes. In order to make up for the loss in revenue from personal taxes, taxes on public utility and telephone bills were increased, as were the fees levied on the registration of cars, driving licences, entertainment duty and colour TV licences.

The implications and the import of these statements are pretty obvious. What is not obvious is to *what degree* these policies will be implemented, and *how* — as well as *when*.

2. *Editor's note:* See for a discussion of the Budget 1978: Lee Fook Hong, *1978 Budget and tax changes* in 32 BULLETIN FOR INTERNATIONAL FISCAL DOCUMENTATION 122 (1978).

## WHAT IS THE FUTURE OF SINGAPORE IN INTERNATIONAL TAXATION?

One approach is to consider the business which many present at this conference specialise in. In tax planning you must keep abreast of all developments which can be exploited to minimise the tax liability of your clients.

It would be futile for me to predict what may or may not come about in terms of specific changes and where Singapore will stand in the international tax league especially as far as loopholes and concessions are concerned.

Taxation as one of the most important components of fiscal policy will undoubtedly be used in the management of aggregate demand. The fight against world inflation will be with us for some time yet.

Of possibly far greater interest to a wider audience will be the use of taxation in shaping what Singapore will be in the decades to come. Taxation will become one of the elements that will most likely be used in a package of measures.

Taxes have already been used to reduce energy consumption. It is very likely that novel and imaginative taxes can be devised to meet the problems which may befall us. The use of tax to influence demographic trends is but a simple example.

The success or otherwise of taxes ultimately rests on the reasonableness of the burden which people have to bear. Government has shown an acute awareness that effort and achievement should be adequately rewarded. As long as this is practised, I see no reason why taxes cannot be used positively and creatively for improving on what we have so far achieved in Singapore.

In other words, if you must tax — tax wisely and intelligently.

# INDIA: Interim Budget 1980

Extract from the Budget Speech 1980 pronounced by the Finance Minister, Mr. R. Venkataraman, on February 29, 1980. The recently elected Indira Ghandi Government has had too little time to present a full-fledged budget which will now be submitted in May or June of this year.

36. I propose to introduce today a Finance Bill which seeks to continue the existing rates of income-tax for the financial year 1980-81. However, I have also three proposals of a non-controversial nature for the amendment of the Income-tax Act. I shall now briefly explain these proposals.

37. Some state governments have set up statutory corporations for the promotion of socio-economic interests of members of the scheduled castes and the scheduled tribes. I propose to exempt from income-tax the income of all statutory corporations or bodies, associations or institutions wholly financed by the Central or a state government, established for promoting the interests of the members of the scheduled tribes.

38. As the Hon'ble members are aware residents of Ladakh were exempted from payment of income-tax up to and including the assessment year 1979-80 in respect of income accruing or arising to them from any source in that district or outside India. I propose to continue the tax exemption for a further period of three years.

39. Under an existing provision, awards for literary, scientific and artistic work or attainment, instituted by the Central government or by any state government or approved by the Central government, are exempt from income-tax. I propose to extend this tax concession to approved awards for outstanding work in alleviation of the distress of the poor, the weak and the ailing. Hon'ble members will be glad to know that this provision will set at rest doubts about the taxability of the Nobel Prize awarded to Mother Teresa in recognition of her service to suffering humanity.

40. There is no change in the rates of customs and Central excise duties. However, provision has been made in the Finance Bill for the continuance of the auxiliary duties of customers and special duties of excise at the existing rates for the year 1980-81.

# Singapore: BUDGET 1980

## A GO-GETTER BUDGET

Extracts from the Budget Speech pronounced by the Minister for Trade and Industry, Mr. Goh Chok Tong, on March 5, 1980.

The FY 1980 Budget has been formulated on the basis of the following guidelines:

(a) *Financial prudence:* We shall continue with the prudent policy of keeping Government recurrent expenditure down to the minimum and within the revenue expected to be collected within the fiscal year, but consistent with a high standard of administration.

(b) *Development objectives:* The Budget should reflect the thrust and objectives of our policy to restructure the economy and of our development strategies for the Eighties. It should balance economic growth with social objectives. Investment in infrastructural development should be matched by investment in people and improvements in housing and other social amenities.

The FY 1980 Budget provides $4,019 million in the "Main estimates". This recurrent expenditure is fully covered by the expected revenue of $4,118 million. It is 19 percent higher than that for the last fiscal year and in my view is the minimum required to maintain the public services at a high standard. The need to exercise effective control over the utilisation of manpower, given our policy to encourage economy in the use of labour, is reflected in a net total increase of only 957 posts, including those created by Establishment Warrant in the course of this current financial year. This is an increase of only 1.4 percent over the FY 1979 establishment. Of these new posts, 533 are for the Ministry of Education in connection with their revised primary education system, the computerisation of education data and establishment of new schools. With the conversion of Radio and Television Singapore into a statutory corporation, 1,422 posts are taken out of the Budget. The FY 1980 establishment will, therefore, be reduced by 465 posts to 69,226 posts compared to the FY 1979 establishment of 69,691.

The Budget, however, recognises that as steps are taken to minimise staff increases, Ministries and Departments have to mechanise, automate and computerise. They must also upgrade or retrain the skills of officers. The Budget therefore provides funds for new and better machines and for computerisation as well as for training of civil servants.

The importance of infrastructural development is again emphasised in the Budget. Forty-seven percent of the FY 1980 Budget, or $3,617 million, is for development. Expenditure on economic services will amount to $1,755 million, or 49 percent of total development expenditure. This includes a sum of $1,047 million for industrial and commercial development (largely as loans to the Jurong Town Corporation and to industrial and commercial enterprises) and $430 million for the development of Changi Airport and roads in the Republic.

Our economic restructuring programme and the long term economic health of our country require that we harness our workers to produce higher value-added and skilled manufactures and services. We must maximise the talents of our people. Human resource development is therefore one of our top development priorities and is reflected in our Budget. More and better education and training of both teachers and students are necessary to upgrade the quality of our workforce. The Budget provides for higher expenditure for our schools, training institutions and universities.

Economic development must bring about a material improvement in social services. A sum of $1,133 million is provided for public housing, accounting for 31 percent of the Development Budget. The provision for economic services and public housing together accounts for 80 percent of the total Development Budget.

### REVENUE: CHEERS AND TEARS

I now move on to tax changes and revenue estimates for the new fiscal year. It is not possible to bring cheers for all. There will be cheers and there will be tears, but our compass must be the overall good of Singapore.

The total revenue estimated for FY 1980 is $4,113 million. This represents a fall in collections of $167 million or 3.9 percent compared with the revised estimates for FY 1979. The drop is due to the exceptionally high revenue receipts in FY 1979 which came from land sales and back payments of land premia and also property tax arrears from statutory boards.

Income tax remains the largest single source of revenue and it is expected to show an increase of 7 percent or $93 million over the revised estimates for FY 1979. For FY 1980, income tax is expected to yield $1,423 million. Property tax collections, however, are expected to fall by some $30 million mainly because of the phased reduction of property tax rates to a level of 23 percent in 1983.

The total budgeted expenditure for FY 1980 is $7,636 million, comprising a recurrent expenditure of $4,019 million and a development expenditure of $3,617 million. The expected revenue of $4,113 million for FY 1980, therefore, falls short of the total Budget by $3,523 million. Of course, we cannot expect to finance the entire development expenditure with Government revenue. The question is how much of this should be financed from public borrowings and how much from additional taxes. I, therefore, come now to the moment of anxiety.

### TAX CHANGES: WITHDRAWAL OF PROTECTION FOR CIGARETTES AND TOBACCO

I have earlier announced that we will not protect local industries against competition from imports. This applies also to the manufacture of cigarettes.

At present, the manufacture of cigarettes is protected through the imposition of an import duty higher than excise duty. Withdrawal of protection is in keeping with the development strategy to expose to competition those industries which should have grown out of the fledgling stage. I have, therefore, decided to remove this protection for cigarette manufacture by harmonizing excise duty with import duty. Excise duty on cigarette manufacture will therefore be raised from $4 per kilogram to $9 per kilogram. The import duty of cut rag will also be increased from $35 per kilogram to $36 per kilogram.

This approach in removing protection is in line with our policy of discouraging smoking.

The revision of duty which is expected to yield an additional $21 million per year will come into effect today.

There is a loss in revenue of $50 million, however, from the general removal of protective duties. The net revenue loss arising from trade liberalization is, therefore, $29 million.

## TAX CONCESSIONS

(i) Research and development

I have earlier dwelt on the plan to promote research and development in the 1980s. The purpose is to encourage manufacturers to develop new products and processes and to modify existing ones. I am pleased to declare that specific tax incentives will be given to promote R & D activities in Singapore.

For manufacturing enterprises conducting R & D and R & D institutions servicing them, the following tax incentives will be given:

(a) Double deduction of R & D expenditure, other than on buildings and equipment, on a case-by-case basis;
(b) Accelerated depreciation over three years for all plant and machinery for R & D;
(c) Investment allowance of up to 50 percent of the capital investment in R & D, excluding building costs, on a case-by-case basis;
(d) Extension of the initial allowance of 25 percent and annual allowance of 3 percent, presently available only to industrial buildings and structures, to R & D buildings; and
(e) Capitalisation and writing-off of lump sum payments for manufacturing licensings for a period of 5 years.

These concessions will take effect from Year of Assessment 1981.

(ii) Capital allowances for plant and machinery

Also, in line with our policy to develop high technology and to assist our enterprises to mechanise, computerise, and upgrade their operations, I have decided to liberalise the tax treatment of capital allowances for plant and machinery as follows:

(a) Accelerated depreciation allowance of 33 1/3 percent over three years will be extended to investment in computers and R & D equipment;
(b) The method of granting annual allowances will be converted from the reducing balance to the straight line method; and
(c) The existing depreciation schedule will be replaced by another with more realistic rates for write-offs. (This schedule is attached as Appendix I to my Budget Statement).

The rates in the new schedule take cognizance of the fact that certain assets promote mechanisation and automation. Hence, these are given increased rates of allowances. To give an example, under the existing scheme, it takes ten years to write off about 70 percent of the cost of machinery not used by "industrial enterprises". Under the new schedule, the machinery will be allowed to be written off completely in six years. The new method applies to both existing and new assets with effect from 1 January 1980. For a depreciable asset bought before the date, the straight line deduction will be computed by dividing the written down value of the asset by the remaining number of years of its estimated life in accordance with the new schedule.

The new method of depreciation together with the new rates for write-off provides for faster depreciation deductions on capital investment. Business firms will have more after tax earnings which they can use to channel into spending on depreciable assets for the purpose of mechanisation and automation.

The loss in revenue in the first year from this tax concession is estimated to be at least $78 million.

(iii) Stamp duties

In previous years, many incentives have been given to promote the development of Singapore as a financial centre. This year, I intend to remove the inconveniences experienced by financial enterprises by removing certain duties altogether and rationalising others at a single rate:

*(a) Mortgages and debentures*
The existing rates of duty on mortgages and debentures will apply but the maximum amount payable is now fixed at $500.

*(b) Marketable securities*
Asian Dollar and Singapore Dollar Bonds are presently granted stamp duty remission on a case-by-case basis. The exemption will now be given across the board.

Stamp duty on contract notes for the trading of marketable securities will also be abolished.

*(c) ACU offshore loan agreements*
The present 1/2 percent ad valorem stamp duty, subject to a maximum of $500 on ACU offshore loan agreements, will be abolished.

In addition, stamp duties on all other documents relating to ACU offshore loans will be abolished.

*(d) Share certificates*
The 0.1 percent ad valorem duty on share certificates will be removed.

*(e) Share transfer deeds*
The 0.2 percent and 0.3 percent duty on share transfer deeds will be standardised at 0.2 percent.

*(f) Insurance policies*
The existing multifarious duties will be standardised at a single rate of $1 per document.

*(g) Partnership agreements*
The existing manifold rates will be standardised at a single rate of $10.

*(h) Promissory notes*
The duty will be revised to $1 per note.

Stamp duties on the following instruments in the First Schedule of the Stamp Act will also be removed completely:

Article 3 — Agreement or memorandum of agreement
Article 7 — Appraisement
Article 8 — Apprenticeship deed
Article 12 — Average bond
Article 13 — Award
Article 25 — Contract
Article 28 — Copy or extract
Article 33 — Deed of any kind not described in this Schedule
Article 37 — Extract
Article 43 — Letter of allotment and letter of renunciation
Article 48 — Note of protest by the master of a ship
Article 54 — Protest of bill or note
Article 55 — Protest by the master of a ship
Article 67 — Valuation
Article 68 — Warrant for goods

The concessions on stamp duties will take effect from 1 April 1980. The loss in revenue is estimated at $10 million in the first year.

(iv) Concession for off-shore gold transactions

I have received representations that the tax rate of 40 percent on income derived from off-shore gold transactions inhibits the development of the market. I have studied the matter and am prepared to remove this disincentive. With effect from Year of Assessment 1981, the 10 percent concessionary tax rate will apply to the following income derived from gold transactions with non-residents:

1) Profits arising from the transactions of Asian Currency Units (ACUs) with non-residents, other ACUs, and broker and dealer members of the Gold Exchange of Singapore (GES) in the Singapore and overseas gold markets. This is an extension of the concession so far given to ACUs on income derived from off-shore transactions with non-residents.
2) Fees, commissions and profits of

approved broker and dealer members of the GES, that is, those approved by the Monetary Authority of Singapore, arising from their transactions with non-residents, other members of the GES, and ACUs, in both the Singapore and overseas gold markets. Associate members of the GES will not be eligible for the concession.

It is hoped that the loss in revenue, estimated at $1.5 million, will be compensated later by the growth of the gold market.

## PERSONAL INCOME TAX

(1) Tax rates

In my Budget Statement last year, I stated that taxes should never be so high as to become a disincentive to hard work or to stifle talents and skill. But "high" is a relative term as different individuals have different thresholds of pain. We know, however, that the wider the tax base the lower the tax burden per capita will be. These are two guiding principles behind this year's tax changes.

As at 31 December 1979, there were 389,387 individual taxpayers, representing an increase during the year of 30,459 taxpayers. The Inland Revenue Department should be able to bring more taxpayers into the net when its computerisation programme is completed. Meantime, steps will be taken to ferret tax evaders.

There have been several representations in the past, including some from my colleagues in the House, to increase the tax reliefs for earned income, dependents and other deductible tax items. I decided against an increase in earned reliefs last year and I am deciding against an increase in any of these reliefs this year. The rationale for this decision is the need to spread income tax to cover as many individuals as possible.

### Across-the-board reduction

*At present less than 38 percent of our work force pay any income tax. The more citizens we have paying income tax, the more voters there are who understand that welfare programmes which sound such attractive giveaways from some magic cornucopia conjured up at election time, must mean an increase in their income tax. Several advanced countries, like Britain, have been hypnotised by this "soak the rich" slogan, only to discover that they have, by heavy taxes on personal incomes, stifled the drive to excel and to succeed of their enterprising and talented, of their professional and even of their skilled workers. We want our skilled workers to increase their earnings as against the unskilled and to pay income tax, but not such that he finds it not worth the time, effort and investment to learn to be a skilled worker. Paying income tax will imprint in the minds of Singaporeans the importance of prudent fiscal and welfare policies since many will have a direct responsibility to pay taxes for Government social expenditure from their own incomes.*

Between increasing the level of deductible reliefs and lowering tax rates across the board to afford reliefs from inflation, I have opted for the latter. My decision is based on sound principle and on precedent, first established by the Deputy Prime Minister as Minister of Finance, and upheld by the present Minister for Finance since 1970. This general reduction in personal tax rates gives relief to all without shrinking our taxpaying population.

Details of the existing and new tax rates are being distributed to Honourable Members and they are attached as Appendix II to my Budget Statement.

Every taxpayer will be given a reduction in tax ranging from 6.8 percent to 19.9 percent, depending on his tax bracket. The average reduction in tax is 16.1 percent. This I consider generous as our Consumer Price Index rose by only 4 percent last year. The substantial reduction is evidence of our intention not to stymie the application of time, talents and effort in earning income which generates economic growth.

The highest marginal rate remains at 55 percent, but the lowest marginal rate is now reduced to 4 percent. Taxpayers in the first and second tax brackets, therefore, enjoy the largest reductions in relative terms. Those in the first taxable bracket will, on average, pay only one percent of their incomes in tax. The others are given tax reductions commensurate with their bigger tax liabilities.

The new rates will take effect from Year of Assessment 1980. The loss in revenue is estimated at $45.5 million out of a total estimated personal income tax collection of $476 million.

### Combatting tax avoidance through rate reduction

The aim of the Government is to reduce the levels of personal income tax in the next 2-3 years until the maximum effective rate is no more than the company rate of income tax, i.e. 40 percent. Then there will be no advantage for people to set up companies from which they draw low salaries for income tax purposes, whilst the bulk of their needs are paid by the company whose profits carry only 40 percent company tax. Such a reduction will be fairer on those wage earners who cannot hide their incomes, and on those professionals who cannot incorporate themselves into private limited companies because their professions disallow it. Also, income tax falls unfairly. Wage earners like those in the Civil Service, who cannot put aside part of their incomes as perks carry a heavier tax burden than those in the private sector who can. There are also some professionals, like doctors, who have a natural advantage in tax evasion over lawyers or accountants because of the nature of the payments, made by patients in cash to doctors, as against cheques by clients, often corporations, to lawyers and accountants.

The Inland Revenue Department will vigorously bring more evaders into the tax net. But we shall be deceiving ourselves if we believe that we can get all successful hawkers, restauranteurs, property brokers and freelancing commercial intermediaries to keep and render proper accounts. It will be many years before we can insist on proper book-keeping and accounting which the developed societies have evolved. Even in these societies, new forms of tax evasion such as barter, or exchange of services, have defeated the tax collector.

### Reward for hard work and high performance

For the next stage of our economic development to succeed, we must make it worthwhile for our young to spend time and effort to acquire skills and knowledge that will enable them to earn and to keep more of their incomes for their efforts. At present those who earn between $20,000 and $100,000 a year, the technicians, engineers, managers and professionals, are carrying the greatest burden of income tax. The Government proposes to spread these tax rates more equitably.

We shall be wise to take note of the results on those societies where personal income tax has been used to equalise spendable incomes in the name of progressive taxation. It has blunted the incentive to outperform one's peers; it has levelled the gifted and the industrious down to the mediocre and the indolent. It has narrowed the difference between what the highly skilled takes home as against the unskilled. The results have been ruinous for economies like Britain. Overemphasis on dividing up the national cake equally has ended up in smaller pieces of a non-growing cake. On the other hand, the Japanese and Germans have concentrated on making the national cake bigger and have achieved it by rewarding hard work and high performance, giving a thicker slice to those who have contributed more. The result, even for the unskilled who are entitled to the thinnest slice, has been a piece of cake larger than a thicker slice of a smaller cake. The moral for us is to concentrate on creating a bigger cake through giving full rewards for effort, skills, hard work and enterprise.

(ii) Relief for handicapped persons

I have one more tax concession in my bag. Some years ago, the Minister for Finance extended the allowance for handicapped children to include those over 16 years of age. This year, I intend to make a modification to this relief. If a tax-payer maintains a brother or sister who is incapacitated by physical or mental infirmity and who does not earn any income and continues to depend on the taxpayer, he will be entitled to claim a deduction of $750. The allowance is presently given only to parents of handicapped persons.

This relief is given only to taxpayers who maintain such a member of the family in the same household. The deduction may also be apportioned if more than one taxpayer maintain the same handicapped brother or sister. It will take effect from Year of Assessment 1980.

## CONCLUSION

The tax changes this year will result in a net revenue loss of $164 million in the coming fiscal year. But if they have the desired effect of stimulating effort and economic activities, this loss will be made good by an expanding economy in subsequent years. In case the signals of tax reductions, in particular, in personal income tax rates, are read wrongly, I want to emphasize that these reductions are given not because we are elated over our good economic performance, or because the Treasury coffers are overflowing, but because we anticipate some very difficult years ahead, including this year. The primary objective of the tax liberalization this year is to create maximum room for Singaporeans to exercise their enterprise to the utmost so that they are better prepared to cross the treacherous waters ahead. Tax is a cost item, and in some instances, an empediment to efficiency and effort. We are reducing this cost and impediment. This is, therefore, a go-better Budget. Individuals, partnerships and corporations must go for the opportunities. They must not delay. They must catch up on skills, technology, modern management and exports. They must not be trapped in indolence and lowskilled, low-valued industries and services.

We face the uncertainty of superpower conflicts in the political and military arena. We face the certainty of higher fuel prices. We face the grim prospect of the region being destabilized by external forces, and the oil life-line being cut.

We are unsure of the outcome of the Presidential Elections in the U.S. this year, and hence the global impact of its policy changes. On the other hand, we are sure of sluggish world economic growth cohabiting with inflation.

We, therefore, have the perfect recipe for trouble. We have spelt out our strategy to deal with the difficult times ahead. If we stiffen our resolve, remain robust, we stand a good chance of pulling through the next few years as planned. But we must dare to achieve, and think ahead.

Saving is essential to the growth of our economy. This year's revenue is estimated to exceed recurrent expenditure by only $94 million. We shall draw down $2,482 million from the Development Fund to finance development expenditure. This still leaves a deficit of $1,041 million in the Development Budget which has to be borrowed from private savings, primarily from the Central Provident Fund. Without this generation of savings in the past, we would have to raise taxes, or curtail our development expenditure, to the long term detriment of our economy. Our economic prosperity today is achieved through a partnership of government and individual effort, public and private savings. Present-day Singaporeans must, therefore, save a part of their earnings to secure their own future, and their children's.

*They must at all times avoid waste. They must not squander their tax rebates.*

## APPENDIX I: NEW SCHEDULE

| | | Period for which annual allowances are given (Years) | Rate assuming initial allowance is claimed (Percent) |
|---|---|---|---|
| 1 | Manufacturing and industrial processing plant and machinery | 6 | 13 1/3 |
| 2 | Office equipment: | | |
| | Furniture and fixtures (Includes furniture and fixtures which are not a structural component of a building.) | 10 | 8 |
| | Data handling equipment (Includes typewriters, calculators, adding and accounting machines, copiers, and duplicating equipment.) | 8 | 10 |
| | Telecommunication equipment | 10 | 8 |
| 3 | Transport equipment: | | |
| | Buses | 6 | 13 1/3 |
| | Business service passenger vehicles | 6 | 13 1/3 |
| | Taxis | 5 | 16 |
| | Trucks, lorries, trailers and vans | 6 | 13 1/3 |
| | Motorcycles and bicycles | 8 | 10 |
| 4 | Electrical equipment (Includes assets such as electrical and industrial apparatus, domestic and commercial appliances, airconditioning and ventilating equipment.) | 8 | 10 |
| 5 | Electronic equipment (Includes assets such as electronic detection, guidance, control, radiation, computation, test and navigation equipment.) | 8 | 10 |
| 6 | Materials and passenger handling equipment (Includes assets such as lifts, escalators, weighing machines, conveyor belts, forklifts, lifting gears, trolleys and cranes.) | 6 | 13 1/3 |
| 7 | Building & construction equipment (Includes assets such as rollers, mixers, piling and drilling plants, loaders, dumpers, excavators, bulldozers and support structure.) | 6 | 13 1/3 |
| 8 | Fire safety device | 10 | 8 |
| 9 | Electric, gas, water and steam, utility plant (Includes tanks and generators.) | 16 | 5 |
| 10 | Wholesale and retail trade service assets (Also includes assets used in such activities as the operation of restaurants and cafes.) | 8 | 10 |

| | | Period for which annual allowances are given (Years) | Rate assuming initial allowance is claimed (Percent) |
|---|---|---|---|
| 11 | Plant for recreation and amusement purposes (Includes assets used in the provision of entertainment services on payment of a fee or admission charge, as in the operation of bowling alleys, billiard and pool establishments, theatres, cinemas, concert halls, amusement parks, and miniature golf courses.) | 10 | 8 |
| 12 | Equipment used in personal and professional services (Includes assets used in the provision of personal and professional services which are not elsewhere classified.) | 10 | 8 |
| | *Special assets* | | |
| 13 | Aircraft | 5 | 16 |
| 14 | Bank vaults | 16 | 5 |
| 15 | Cable cars and equipment | 12 | 6 2/3 |
| 16 | Containers | 10 | 8 |
| 17 | Farming equipment | 8 | 10 |
| 18 | Floating and dry docks | 16 | 5 |
| 19 | Gas cylinders | 16 | 5 |
| 20 | Motion picture films | 5 | 16 |
| 21 | Musical instruments and other related assets | 10 | 8 |
| 22 | Railway wagons, lines and related equipment | 16 | 5 |
| 23 | Cables and related assets | 16 | 5 |
| 24 | Vessels, barges, tugs and similar water transportation equipment | 16 | 5 |



## APPENDIX II: PROPOSED REDUCTION IN INDIVIDUAL INCOME TAX

| Chargeable income group | Existing rates % | Proposed rates % | Average tax paid $ | Average reduction in tax $ | Average reduction in tax % | Effective tax rate at end points % | Effective tax rate at end points % |
|---|---|---|---|---|---|---|---|
| 1 - 2,500 | 5 | 4 | 63.30 | 12.60 | 19.9 | 5.0 | 4.0 |
| 2,501 - 5,000 | 8 | 7 | 216.40 | 36.20 | 16.8 | 6.5 | 5.5 |
| 5,001 - 7,500 | 10 | 9 | 443.40 | 61.30 | 13.8 | 7.7 | 6.7 |
| 7,501 - 10,000 | 12 | 11 | 723.60 | 86.50 | 12.0 | 8.8 | 7.8 |
| 10,001 - 15,000 | 15 | 14 | 1,220.70 | 121.80 | 10.0 | 10.8 | 9.8 |
| 15,001 - 20,000 | 20 | 17 | 2,107.90 | 219.80 | 10.4 | 13.1 | 11.6 |
| 20,001 - 25,000 | 25 | 21 | 3,253.90 | 395.10 | 12.1 | 15.5 | 13.5 |
| 25,001 - 35,000 | 30 | 26 | 5,183.70 | 674.80 | 13.0 | 19.6 | 17.1 |
| 35,001 - 50,000 | 35 | 32 | 9,189,00 | 1,096.30 | 11.9 | 24.3 | 21.6 |
| 50,001 - 75,000 | 40 | 34 | 16,218.40 | 1,964.00 | 12.1 | 29.5 | 25.7 |
| 75,001 - 100,000 | 40 | 36 | 26,372.40 | 3,266.00 | 12.4 | 32.1 | 28.3 |
| 100,001 - 200,000 | 45 | 40 | 45,625.00 | 5,469.50 | 12.0 | 38.6 | 34.1 |
| 200,001 - 400,000 | 50 | 45 | 109,703.90 | 12,107.90 | 11.0 | 44.3 | 39.6 |
| 400,001 - 600,000 | 55 | 50 | 219,938.70 | 22,759.30 | 10.3 | 47.9 | 43.0 |
| > 600,000 | 55 | 55 | 423,798.20 | 28,850.00 | 6.8 | – | – |

## From other parts of the Budget Speech

### DEVELOPMENT OF FOREIGN TRADE

The Trade Development Section in the Department of Trade will continue to carry out the task of trade development effectively. We will expand and revitalise the Commercial Secretary Service. We will set up two new trade offices, in the E.E.C., in addition to the existing four. We have signed a trade agreement with China at the end of last year, and are discussing the setting up of trade offices in China. We will consider the setting up of a computerised trade information system to provide trade and commercial data. We will continue our support, including fiscal incentives for local manufacturers to participate in overseas trade fairs and missions. The double tax deduction scheme will be extended to cover overseas marketing campaigns. Through the tax incentives for international trading companies, we will encourage the formation of multi-activity international trading companies to push the export of Singapore manufactured products in overseas markets. The Trade Development Committee with private sector representation has been meeting to discuss trade problems and prospects. It should continue to do so and perform an effective role as an advisory committee to the Department of Trade.

### ECONOMIC POLICY: CONCLUDING REMARKS

In the Budget Statement last year, I remarked that the world in 1979 looked like becoming a more difficult place to make a living in. I was not wrong in my assessment. But, happily, Singaporeans responded with an extra spurt. We ended 1979 with a performance better than 1978's. The world in the 1980s, including 1980, does not look like a bed of roses either. But there is a streak in the Singaporeans that gives us confidence, and that is, they dare to achieve. Our job as a government is to set out our objectives, direction and modus operandi clearly and unequivocally, and lead. The rest is up to Singaporeans to achieve and excel.

It is this quality in Singaporeans, to compete and excel, that gives confidence of success in further liberalization of the economy as we restructure.

In the latter part of the Sixties, we began to shift away from import-substitution industries. We recognised that a policy of import-substitution behind tariff walls will at best give us short-term gains but will stifle our growth in the longer term. Protected industries, sheltered from competitive pressures, will become inefficient and stunted in their growth potential. Moreover, as we depend on the world markets for large scale expansion of manufacturing activities, our products must be internationally competitive. This cannot be achieved with tariff protection.

We therefore stopped introducing new protective duties around 1968. In 1973 and 1977 we removed a wide range of protective duties. Last year, we announced that the protection of locally assembled motor vehicles will cease from 1st August 1980. Nevertheless, there are still a number of protective tariffs remaining. These duties have been in existence for more than a decade. The protected industries should have grown into adulthood by now. If not, they will never mature.

Singpore practises what it preaches. We preach free trade and open competition. We shall, therefore, remove all protective duties other than those included in the ASEAN Preferential Trading Arrangement (PTA), most immediately, some in phases. Details of these tariff removals or reductions will be gazetted by the Ministry of Finance separately.

We have offered our ASEAN partners preferential tariffs on a number of items under the ASEAN Preferential Trading Arrangement. These duties will have to remain as we have to fulfil our commitments. The level of these duties, however, will be reduced as we progress in the ASEAN PTA exercise.

Mr. Speaker, Sir, I have included the discussion of protective duties in my Concluding Remarks instead of in the main body on Development Strategies because our action to remove tariff protection has an impact wider than the direct effect on the industries concerned. Our action removes the last vestiges of protectionism in the pursuit of an open, competitive economy wedded to the world's fortunes. It is an act of confidence.

# IFA NEWS

### British Branch

On January 8, 1980 the British Branch of IFA held a "Tax Workshop" whose main theme was "The limits of tax avoidance". Speakers were Mr. Alun G. Davies and Dr. Barry Bracewell-Milnes who were so kind as to submit their papers for publication by the International Bureau of Fiscal Documentation. These papers appeared in the January 1980 issue of EUROPEAN TAXATION.

The next "Tax Workshop" was held on March 6, 1980 and dealt with "Exchanges of information and extra-territorial claims by the Revenue Authorities". Speakers were Mr. Arthur Johnstone and Mr. John Reynolds.

The newly formed Manchester Branch of the British IFA met on March 20, 1980 where Mr. Joel Barnett spoke on "Treasury Ministers and the Inland Revenue — decision making".

### Anglo-U.S. Seminar, New York

On May 8-9, 1980 a joint British-U.S. international tax seminar will be held in New York. The draft program shows that subjects to be discussed are, inter alia, the British Advance Corporation Tax and withholding taxes under the new U.K.-U.S. tax treaty; unitary taxation in the United States; employee problems; investments in the United Kingdom and the United States and interpretation of statutes and ruling procedures.

### 35th IFA Congress in West Berlin: New dates

Due to unforeseen circumstances the organisers of the 1981 IFA Congress in West Berlin had to change the earlier announced dates. The Congress will now be held from September 21 through 25, 1981.

# TAXATION AND ECONOMIC BEHAVIOR:

## A Review of Recent Literature

By Nizar Jetha *

*Empirical research, including econometric, is indispensable for assessing economic effects of taxation. Theory is frequently inconclusive, and at best, can only identify the relevant factors, whose relative strengths must then be determined by other methods. Empirical research has formed an integral part of recent developments in public finance. This paper reviews some recent research on the effects of taxation on labor supply, saving and risk taking. The emphasis will be on the kind of questions that are being asked and the tentative conclusions that have emerged rather than on theoretical underpinnings of hypotheses and problems of statistical methodology.* [1] *All evidence considered here relates to the United States.*

### SUPPLY OF LABOR

Theory provides a clear-cut framework for studying the effect of a change in wage rate on labor supply. Consider a reduction in the wage rate. This would make leisure more attractive in relation to work, thereby inducing an individual to increase his consumption of leisure (or equivalently, to reduce his supply of labor). On the other hand, the loss of income due to lower wages would induce the individual to reduce the consumption of leisure (or equivalently, to increase his supply of labor). These effects are known as *substitution* and *income effects*, respectively. The former captures, in the present context, the response of labor supply to a change in relative prices (wage rate) with utility (or income) held constant, while the latter captures the response to a change in income with relative prices held constant. The total effect of a change in wage rate on labor supply will be given by the sum of substitution and income effects. The former will be positive since a change in wage rate (with income constant) will induce a change in labor supply in the same direction; the latter will normally be negative since a change in income (with wage rate constant) will tend to induce a change in labor supply in the opposite direction. The total effect would, therefore, depend on the relative strengths of a positive substitution effect and a negative income effect.

Empirical studies express total and substitution effects in the form of elasticities. The total (uncompensated) elasticity is derived from the total effect while the substitution (compensated) elasticity is derived from the substitution effect. [2] Assessment of the supply responses of factors to changes in their rewards, which is the subject of this paper, requires knowledge of uncompensated elasticities. However, in other problems in public finance, such as those concerned with the welfare implications of distortions in resource allocation, the relevant elasticity is the compensated elasticity since economic efficiency is a function solely of relative prices.

In practice, it has proved difficult to disentangle income and substitution effects. One of the first studies that tried to do this is by Kosters. [3] The study included an analysis of the effects of wage rates on the labor supplied by married males aged 50-64 years. The labor supply was defined alternately as the number of hours worked per week and year. An equation that gave right signs for all coefficients implied an uncompensated wage rate elasticity of -0.09 and a compensated wage rate elasticity of +0.04. The total elasticity is relatively low, but its negative sign suggests a backward sloping supply curve of labor ( that is, hours of work vary inversely with the wage rate). This finding has been frequently confirmed for males. It should be stressed, however, that the study did not explicity allow for the effects of taxation.

Since married women often work primarily to supplement family income and since the marginal tax rates applied to their earnings depend on their husbands' earnings, tax considerations can be expected to be an important determinant of the labor supplied by married women. To test whether the number of hours worked

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1. Two excellent surveys on the economic effects of taxation, but of a different kind from the present one, will be found in George F. Break, "The Incidence and Economic Effects of Taxation" in A. Blinder *et al.*, *The Economics of Public Finance* (The Brookings Institution, 1974), and Michael J. Boskin, "On Some Recent Econometric Research in Public Finance, " *American Economic Review*, May 1976.
2. The effect of a change in wage rate on labor supply can be represented mathematically as follows:

$$\frac{\partial L}{\partial W} = \left(\frac{\partial L}{\partial W}\right)_{\text{utility = constant}} + L\,\frac{\partial L}{\partial Y}$$

where L = labor supply, W = wage rate and Y = income. The expression on the left is the total effect, and the first and second terms on the right represent substitution and income effects, respectively. Multiplying both sides of the above equation by W/L gives

$$\frac{W}{L}\,\frac{\partial L}{\partial W} = \frac{W}{L}\left(\frac{\partial L}{\partial W}\right)_{\text{utility = constant}} + W\,\frac{\partial L}{\partial Y}$$

where the expression on the left represents the uncompensated elasticity of labor supply and the first term on the right the compensated elasticity of labor supply. For a general derivation of income and substitution effects and their interpretation, see James M. Henderson and Richard E. Quandt, *Microeconomic Theory: A Mathematical Approach* (Second Edition, McGraw-Hill, 1971).
3. Marvin Kosters, "Effects of an Income Tax on Labor Supply," in A. Harberger and M. Bailey (eds.), *The Taxation of Income from Capital* (The Brookings Institution, 1969).

by women depend on gross or net of tax wages, Rosen [4] estimated the following model:

$$\text{HOURS}j = A_1 (1 - ptj)\, \text{WAGE}j + \sum_{i=1}^{n} BiXij$$

where HOURSj = the jth married woman's hours of work, WAGEj = her gross wage, tj = her marginal tax rate, Xij = all other relevant factors (e.g. number of young children, other family income, etc.) and p = a parameter of tax perception. It is clear that p = 0 would imply that individuals react to gross wages, whereas p = 1 would imply that they react to net wages. An estimate of p of close to 1 was found, suggesting that the tax structure does indeed have an effect on the labor supply of married women. The results of the study imply an elasticity of supply for married women (working half time) of between 1.3 and 1.9. [5]

Evidence of a different kind concerning the impact of taxation on work effort has come from negative income tax experiments. One of the first such experiments was carried out in New Jersey. [6] The experiment involved payments of income subsidies (ranging from 50-125 percent of poverty line) to low-income families, and the imposition of tax rates of 30-70 percent on the other income of those families. Since the working poor simultaneously faced higher marginal tax rates (lower net wages) and an income subsidy, both substitution and income effects could be expected to reduce the amount of work supplied. A substantial decline in the labor supply of the participants was, therefore, expected. The evidence, however, did not bear this out; there was only a small (five to six percent) reduction in average hours worked by the male heads of families who received negative income tax payments.

Thus, contrary to popular notions which attribute to taxation substantial disincentives to work, empirical evidence is often inconclusive or reveals only modest disincentive effects (for males). While taxpayers will tend to exaggerate the impact of taxation, part of the discrepancy between the taxpayers' perceptions and empirical evidence may be due to the difficulties of capturing the complexity of the process of work decisions within a family in a model, and of measuring the supply of labor. The latter needs some elaboration. Measuring labor supply by the number of hours worked, either weekly or annually, may not reveal much about the disincentive effects of taxation where institutional factors preclude the variation in work hours by a large proportion of the labor force. In such a situation, the disincentive effects are likely to be reflected in reduced intensity of work, lesser willingness to change jobs and other kinds of work behavior. Empirical studies may have, therefore, seriously underestimated the effects of taxation on work effort by concentrating on the hours worked. Quantification of the other ways in which disincentives may manifest themselves is, however, easier said than done.

## SUPPLY OF SAVING

Theory cannot tell us even the sign of the substitution effect where the response of saving to a change in the rate of interest is concerned. All that the theory predicts is that an increase in the rate of interest (that is, a decline in the price of future consumption in terms of the present consumption forgone) would induce an individual to demand a higher *quantity* of future consumption. But current saving is the *expenditure* on future consumption. This need not necessarily increase when the price at which future consumption may be purchased declines, since a higher quantity of future consumption may now be purchased with the previous level of saving. [7]

The view that interest rates have little, if any, effect on private (personal plus corporate) saving is widely held. The historical stability of the gross private saving rate (GPSR), [8] defined as gross private saving as a proportion of GNP, [9] and the failure of most studies to find a significant interest elasticity of saving are responsible for this view. The absence of a trend in the GPSR has become known as "Denison's Law" and has been given various behavioral interpretations.

Among the first studies to find a substantial interest elasticity of private saving is the one by Wright. [10] Working with consumption, rather than directly with saving, the study estimated a consumption function of the form:

$$C = a + bY + cW + dr$$

where C = consumption, Y = expected income [11] W = net worth and r = net of tax return on corporate bonds. [12] The consumption, income and net worth variables are defined in per capita terms to allow for the effect of population growth. The study found interest elasticities of saving [13] ranging from 0.18 to 0.27. [14]

4. H. Rosen, "Tax Illusion and the Labor Supply of Married Women, " *The Review of Economics and Statistics*, May 1976.
5. The study is based on a sample in which a large proportion of women were not part of the labor force. Furthermore, the particular statistical specification used implies that the number of hours worked does not affect the hourly wage rate. These considerations need to be borne in mind in interpreting the results.
6. Joseph A. Pechman and P. Michael Timpane (eds.), *Work Incentives and Income Guarantees, The New Jersey Negative Income Tax Experiment* (The Brookings Institution, 1975).
7. Martin Feldstein, "The Rate of Return, Taxation and Personal Savings," *The Economic Journal*, September 1978.
8. Paul David and John L. Scadding, "Private Saving: Ultrarationality, Aggregation and 'Denison's Law'", *Journal of Political Economy*, March/April 1974.
9. In this connection, saving is defined as gross private saving plus consumer expenditure on durables; and GNP correspondingly includes imputed annual income from consumer durables.
10. Colin Wright, "Saving and the Rate of Interest," in A. Harberger and M. Bailey (eds.), *Taxation of Income from Capital* (The Brookings Institution, 1969).
11. Expected income is normally derived as a function of past incomes.
12. Difficulties associated with the choice of an appropriate rate of return on capital will not be considered here.
13. The national accounting identity, C = Y—S, where C = consumption, Y = income and S = saving, implies that $\frac{\partial C}{\partial r} = -\frac{\partial S}{\partial r}$. The interest elasticity of saving, $\frac{r}{S}\frac{\partial S}{\partial r}$, can, therefore, be derived from $\frac{\partial C}{\partial r}$, the estimated coefficient of r in the consumption function.
14. These appear to be compensated elasticities.

In an important recent contribution, Boskin has criticized behavioral interpretations of Denison's law and has extended Wright's research.[15] Expressing GPSR as:

$$GSPR = \frac{GPS}{GNP} = \frac{GPS}{DPI} \times \frac{DPI}{GNP}$$

where GPS = gross private saving and DPI = disposable private income, he notes that since DPI/GNP has fallen substantially due to growth of taxation, the constancy in GPSR must be due to a substantial increase in gross private saving out of disposable private income. Taking account of this observation, his direct test of the responsiveness of saving to the rate of interest consists of estimation of functions of the form:

$$\ln Ct = a + b \ \ln DPIt + c \ \ln DPIt - 1 + d \ \ln Wt - 1 + e \ \ln Ut + f\, Rt$$

where Ct = per capita private consumption, DPIt = per capita private disposable income, Wt = per capita wealth at the end of period t, Ut = the rate of unemployment, Rt = the real after-tax return on capital, and ln represents natural logarithms. This study finds an elasticity (uncompensated) of private saving with respect to the real net of tax rate of interest of 0.4, which is much higher than previous estimates. An elasticity of this magnitude is significant for policy purposes since it implies, for instance, that an increase in the real after-tax return from 4 percent to 5 percent could be expected to raise the gross private saving rate from 20 percent to 22 percent.

Although Boskin's work deals with taxation and inflation more carefully than previous studies, criticism of his work has centered on his derivation of the expected real after-tax rate of return.[16] This is not altogether surprising in view of the difficulties of specifying expectations concerning interest rates and inflation in a completely satisfactory way. While Boskin's results remain controversial, his work has prompted further research on the relationship between private saving and rate of interest.

A sizable proportion of private saving takes the form of corporate retained earnings, contributions to pension schemes and private housing. The high degree of aggregation involved in studies of total private saving results in a neglect of institutional factors affecting the composition of saving. The aggregative consumption and saving functions also mask the interrelationship between different forms of private saving. The relationship between corporate and private savings is particularly important because the tax structure provides substantial encouragement to the retention of corporate earnings. Does the higher corporate saving induced by tax incentives raise the rate of private saving or is it offset by lower personal saving? A similar question may be asked concerning social security. Do social security contributions raise overall saving or are they treated as a substitute for personal saving? Questions of this kind have received growing attention, but no unambiguous conclusions have so far emerged.

Feldstein has examined the relationship between corporate and personal saving by postulating that real accrued capital gains due to retained earnings are likely to be of a more permanent nature and consequently could be expected to exercise a stronger effect on consumption than those arising from a revaluation of existing assets.[17] However, lacking separate data on these two components of real accrued gains, he estimated models of the following form:

$$Ct = a + bYt + cWt - 1 + dGt + eREt$$

where Ct = consumption expenditure, Yt = disposable income, Wt = the stock of wealth at the end of period t, Gt = accrued capital gains and REt = retained earnings, all defined in per capita terms. With this specification, the coefficient of retained earnings represents the excess effect of retained earnings over capital gains in general. The coefficient of accrued gains was found to be small, but the marginal propensity to consume retained earnings (e) amounted to about two-thirds of the long-term marginal propensity to consume disposable income, implying that higher corporate saving will tend to be largely offset by lower personal saving, leaving private saving unchanged.

This conclusion has been questioned in a recent paper by Bhatia.[18] Bhatia contends that Feldstein's aggregative method of calculating accrued gains — that of deducting personal saving from changes in household wealth — gives unreliable figures. Instead, he derives accrued gains more directly by aggregating accrued gains on major household assets (corporate stock, nonfarm real estate and some farm assets). Using the series on accrued gains thus computed did not give significant coefficients either for accrued gains or retained earnings. This suggests that corporate saving has no effect on personal saving, except through expected capital gains which are treated as additions to their wealth by households. The effect of wealth on consumption tends to be relatively weak, however.

Social security will have two countervailing effects on personal saving. The availability of benefits during retirement will tend to reduce private saving in the working years. At the same time, by encouraging early retirement, social security will induce greater private saving since provision must be made for a longer retirement period. To determine the net effect of these tendencies on personal saving, Feldstein has employed a model similar to that used for assessing the relationship between corporate and personal saving.[19] The model is of the form:

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15. Micheal J. Boskin, "Taxation, Saving and the Rate of Interest," *Journal of Political Economy*, April 1979 (Part 2).
16. E. Philip Howrey and Saul H. Hymans, "The Measurement and Determination of Loanable Funds Saving," *Brookings Papers on Economic Activity*, 3:1978.
17. Martin Feldstein, "Tax Incentives, Corporate Saving, and Capital Accumulation in the United States," *Journal of Public Economics*, April 1973.
18. Kul B. Bhatia, "Corporate Taxation, Retained Earnings and Capital Formation," *Journal of Public Economics*, February 1979.
19. Martin Feldstein. "Social Security, Induced Retirement, and Aggregate Capital Accumulation," *Journal of Political Economy*, September/October 1974, and "Social Security and Saving: The Extended Life Cycle Theory," *American Economic Review*, May 1976.

$Ct = a + bYt + cWt-1 + dSSWt$

where Ct = consumption expenditure, Yt = disposable personal income, Wt = net worth at the end of period t, and SSWt = gross social security wealth ("the present value in year t of the retirement benefits which could eventually be claimed by all those who are either in the labor force or already retired in year t"). All variables are in per capita terms. The main conclusion of the study is that social security reduces private saving by at least 30 percent. Feldstein has found further support for his conclusion from research based on cross-section data. [20] Other studies have, however, found the effect of social security on personal saving to be much lower [21] or indeterminate. [22]

Should further research confirm Feldstein's findings, its implications for the present social security arrangements would require careful consideration. Reduced private saving due to social security would be of no consequence if it were offset by increased public saving. In a funded social security scheme with an accumulated reserve fund, a decline in private saving would be at least partially offset by an increase in public saving. However, in the pay-as-you-go social security system of the United States, where contributions are almost wholly paid out as benefits, lower private saving would not be compensated by higher public saving. A decline in private saving would, therefore, reduce overall national savings. This possible effect is viewed with concern by those who believe that a higher rate of capital accumulation would be desirable.

## PORTFOLIO COMPOSITION

The effect of taxation on risk taking is also theoretically inconclusive. A pioneering study of this subject showed that a proportional income tax on total income (including capital gains) would encourage greater risk taking (that is, a shift to a portfolio that is characterized by a higher expected yield as well as greater uncertainty concerning the realization of that yield) provided that capital losses could be fully offset against other income. [23] This conclusion was confirmed in a more modern theoretical framework based on expected utility. [24] The reason for this counter-intuitive result is that a proportional income tax reduces both yield and risk in the same proportion. In this situation, an individual will wish to obtain the same combination of yield and risk as in the pre-tax situation but, to obtain that combination in the presence of the tax, the proportion of assets held in the risky asset would have to be increased. This analysis depends critically on the existence of a riskless asset with no yield, a requirement that will not be fulfilled in a world of uncertain inflation rates. Later work has shown, however, that no statement concerning the impact of taxation on risk taking can be made in a completely general framework. [25] To discover the effect of taxation on portfolio composition, one must, therefore, turn to empirical analyses.

The first econometric study on the effect of taxation on portfolio composition was undertaken by Feldstein. [26] The study examined the influence of the tax structure on the holdings of financial assets such as common stock, preferred stock, municipal bonds, savings bonds, other bonds and bank accounts. Utilizing household data, Feldstein estimated functions of the form:

Pji = f (tax class, wealth class, age, sex,
human capital/nonhuman capital)

where Pji = proportion of the ith individual's portfolio held in assets of type j. The study's most striking conclusion is that the proportion of portfolio held in common stock increases substantially with marginal tax rates (and income). The share of common stock in the portfolio was found to increase by over 30 percent from the lowest tax bracket to the highest.

The effect of taxation on relative net yields realized on different assets by each individual provides the main explanation for this result. While all individuals will receive identical gross yields, the relative net yields received by different individuals will vary due to differences in marginal tax rates and special features of the tax system. The main stimulus to the demand for equities comes from the fact that, largely due to the preferential treatment of capital gains, relative net yields on common stock increase with income. Thus, the strong positive association between high tax rates and holdings of common stock, while suggestive, does not imply that high marginal rates of tax *per se* encourage investment in common stock and other risky assets. Further research to clarify the relationship between taxation and risk taking is clearly needed.

In another article, Feldstein and Yitzhaki have examined the effect of capital gains tax on sales of common stock. [27] Two types of transactions are distinguished: "switching", where sales of common stock are followed

20. Martin Feldstein, "Social Security and Private Savings: International Evidence in an Extended Life-Cycle Model," in Martin Feldstein and Robert P. Inman (eds.), *The Economics of Public Services* (Macmillan, 1977), and Martin Feldstein and Anthony Pellechio, "Social Security and Household Wealth Accumulation: New Macroeconometric Evidence," *Review of Economics and Statistics*, August 1979.
21. Alicia H. Munnell, *The Future of Social Security* (The Brookings Institution, 1977).
22. Robert J. Barro, *The Impact of Social Security on Private Saving* (American Enterprise Institute, Washington, D.C., 1978); Robert J. Barro and Glenn M. MacDonald, "Social Security and Consumer Spending in an International Cross Section," *Journal of Public Economics*, June 1979; and Louis Esposito, "Effect of Social Security on Saving: Review of Studies Using U.S. Time Series Data," *Social Security Buletin*, May 1978.
23. Evsey D. Domar and Richard A. Musgrave, "Proportional Income Taxation and Risk Taking", *Quarterly Journal of Economics*, May 1944.
24. J. Tobin, "Liquidity Preference as Behaviour Towards Risk," *Review of Economic Studies*, February 1958.
25. Martin Feldstein, "The Effects of Taxation on Risk Taking," *Journal of Political Economy*, September 1969.
26. Martin Feldstein, "Personal Taxation and Portfolio Composition: An Econometric Analysis, " *Econometrica*, July 1976.
27. Martin Feldstein and Shlomo Yitzhaki, 'The Effects of the Capital Gains Tax on the Selling and Switching of Common Stock," *Journal of Public Economics*, February 1978.

by purchases of different stock, and "net sales", where proceeds from sales of common stock are not reinvested. Household data are utilized to explain the ratio of "switches" to the value of common stock holding, as follows:

$$\frac{\text{Value of switches of common stock}}{\text{Value of common stockholding}} = \text{f (capital gains tax rate, age, value of stock holdings, income class)}$$

The results, based on a marginal rate of capital gains tax of 15 percent, suggest that "switches" would have been over three times larger (than they were) in the absence of the capital gains tax. The evidence, thus, supports the conjecture that the taxation of capital gains on a realization basis, by permitting the postponement of the tax until assets are sold, significantly discourages stock sales for the purpose of portfolio reallocation. As is to be expected, tax considerations were not found to be important in decisions concerning "net sales".

## CONCLUDING REMARKS

The inconclusiveness of many studies and the simplicity of statistical specifications stand out. As more data become available, hypotheses and econometric techniques of greater sophistication can be expected to be utilized. Nonetheless, the recent studies, with their careful examination of the old questions and formulation of new ones, are bound to influence the direction of future empirical research on the impact of taxation on economic behavior.

# United States – Netherlands Antilles

### Revenue Ruling 80-4: Foreign tax credit

A payment to the Netherlands Antilles pursuant to the election described in Rev. Rul. 65-16 is a payment made pursuant to a legal liability for purposes of Sec. 901(b) of the Code; Rev. Rul. 65-16 amplified.

*Issue.* Is a payment to the Netherlands Antilles pursuant to the election described in Rev. Rul. 65-16, 1965-1 C.B. 626, a payment made pursuant to a legal liability for purposes of the foreign tax credit provided in section 901(b) of the Internal Revenue Code?

*Law.* Rev. Rul. 65-16 holds that a Netherlands Antilles corporation electing to be taxed under Article 8A of the National Ordinance on Profit Tax of 1940 of the Netherlands Antilles, as added by the National Ordinance of December 30, 1963, may be entitled to the tax benefits that are accorded by Articles VII, VIII, and IX of the United States-Netherlands Income Tax Convention, 1950-1 C.B. 92, as extended to the Netherlands Antilles, 1956-2 C.B. 1116.

Section 901(b) of the Code generally allows qualifying United States taxpayers to claim a foreign tax credit for the amount of any income taxes paid or accrued during the taxable year to any foreign country subject to certain limitations.

Section 902(a) of the Code provides generally that domestic corporations owning at least 10 percent of the stock of a foreign corporation from which it receives dividends paid out of accumulated profits shall be deemed to have paid a certain portion of any creditable foreign income tax paid or deemed to have been paid by such foreign corporation on or with respect to such accumulated profits.

For purposes of claiming a credit under section 901(b) of the Code for the payment or accrual of an amount to a foreign government, such payment or accrual must constitute a tax liability to the foreign government. *See* Rev. Rul. 76-215, 1976-1 C.B. 194. Only the taxpayer liable for the tax may claim a credit under section 901 and only in the amount for which the taxpayer is liable. *See* Rev. Ruls. 72-370, 1972-2 C.B. 437 and 59-101, 1959-1 C.B. 189. When a credit is being claimed pursuant to section 902(a) by a domestic parent corporation for amounts paid or accrued to a foreign government by its foreign subsidiary, such amounts must also constitute a tax liability to the foreign government. A payment of an amount to a foreign government that is not made pursuant to a legal tax liability could be a contribution to such government rather than a payment of a tax. *See* Rev. Rul. 76-508, 1976-2 C.B. 225.

*Holding.* A payment to the Netherlands Antilles pursuant to the election described in Rev. Rul. 65-16 will be considered a payment made pursuant to a legal liability for purposes of the foreign tax credit provided in section 901(b) of the Code under the United States-Netherlands Income Tax Convention as extended to the Netherlands Antilles.

*Effect on Other Revenue Rulings.* Rev. Rul. 65-16 is amplified.

# UNITED KINGDOM BUDGET 1980
## New Medium-term Strategy

Extracts from the Budget Speech which was pronounced on March 26, 1980 by the Chancellor of the Exchequer, Sir Geoffrey Howe.

**The tax measures relate to: high pay settlements — high oil prices — high exchange rate.**

The tax measures which I am about to announce are consistent with the medium-term strategy and the overall budgetary framework. They also take account of the changes in the balance of the economy which have come about over the last year.

Many are made necessary only by the impact of inflation upon the tax system. One of the many reasons why we need to master inflation — though not perhaps the most important — is that it would enable Chancellors to make much shorter Budget speeches.

Three developments in particular have influenced me: high pay settlements, high oil prices, and the high exchange rate.

Together, these developments have swung the balance strongly in favour of consumers and against companies, in particular against those companies facing competition from overseas, whether in home or overseas markets.

Consumers have lost something as a result of the increase in oil prices. But the great majority have more than made up for this by big pay increases and the benefit they have received from income tax cuts, the high exchange rate and lower prices for imported manufactures.

In 1979, average personal after-tax incomes increased by 20 percent, while the profits of companies not engaged in North Sea operations fell by over 5 percent in money terms, and of course by much more in real terms.

In deciding the balance of my tax changes, I see a stronger case for reducing the real burdens on companies and small businesses than on private individuals.

Of course, not all companies have lost out. The oil companies are making large windfall profits. The banks are gaining from high interest rates. Some of these are in a position to contribute more by ways of taxation.

The financial position of most sections of business will be eased as interest rates come down.

So far as tax changes are concerned, I shall concentrate the limited funds available to me on encouraging enterprise and on relieving specific pressures which are particularly damaging or unfair.

### PETROLEUM REVENUE TAX UP

The Government's objective in taxing North Sea oil operations must be to strike a balance between the nation's claim to a share in the profits from this national resource, and the right of those engaged in the risky business of oil exploration and development to a fair return on their efforts.

Since my last Budget, world oil prices have increased dramatically. North Sea oil prices, which follow world prices, have risen by more than half from about \$20.70 to some \$33.75 a barrel.

This substantial change has greatly favoured the oil companies. I propose, therefore, for chargeable periods ending on 30th June next and subsequent periods, to increase the rate of Petroleum Revenue Tax from 60 percent to 70 percent.

At the same time, I propose to rectify some anomalies in the PRT rules concerning transfers of North Sea interests between oil companies, and the taxation of gas. These are changes which the industry has requested.

I also propose to introduce special PRT provisions for fields which span the median line between the UK and the Norwegian Continental Shelves.

I have one further proposal on Petroleum Revenue Tax. It relates to the collection of tax. The PRT structure gives companies very early relief for capital expenditure. This means that PRT is not collected until some considerable time after a field has come on stream.

The increases in oil prices have greatly strengthened the industry's cash position. I am satisfied that PRT payments can in future be made somewhat earlier. The Petroleum Revenue Tax Act, 1980, went some way in this direction. I now propose to go slightly further. We shall require companies which are liable to PRT for the chargeable period to June 30, 1981, to make at the beginning of March 1981 an advance payment for that chargeable period at a rate of 15 percent based on 1980 liabilities.

Advance payments for later chargeable periods will be made in the same way but not necessarily at the same rate. These advance payments will be offsettable against normal payments of PRT.

In total the changes in oil company taxation are expected to bring in an extra £535m, making a total of Petroleum Revenue Tax, Corporation Tax and royalties for 1980-81 of rather over £4bn. We are thus ensuring that the nation as a whole secures a proper share of North Sea profits this year.

North Sea oil adds to national income mainly through increased Government revenues and oil company profits. Though the sums of money are large, we must not exaggerate them.

Even in the years of peak production later this decade, no more than 6 percent of GNP is expected to come from the North Sea,equivalent to perhaps two years of the kind of economic growth we achieved in the 1950s and 1960s.

This makes it all the more important that we should use the oil wisely, with an eye to our long-term economic interests.

In particular, we should take the opportunity offered by the growth of oil revenues to bring the level of public sector borrowing steadily down, and this is what our medium-term strategy envisages.

### BANKS: WINDFALL PROFITS

In recent weeks there has been a good deal of comment about the profits declared by the clearing banks. Some represent a "windfall" to the banks, which arises from the combination of high interest rates and the fact that interest is not paid on current accounts.

The windfall element is not a sign of enterprise or efficiency, as the banks themselves recognise. But it is equally irrational to attribute these profits to some wickedness on the part of the banks.

They need the major part to strengthen their capital base, which would otherwise have been eroded by inflation.

There could, of course, be a case in principle for a special tax related to the windfall element in these profits, and I shall be considering this further. However, it has not yet been established that such a tax is either practical or entirely desirable in today's conditions.

Leasing, in which the banks have been heavily involved, has grown rapidly in the past few years. Underlying this growth has been the 100 percent capital allowance, which leasing companies can claim on assets bought for leasing.

The present rules apply to equipment leased to UK industrial and commercial companies, which would qualify in their own right for these tax incentives if they were to purchase the equipment for themselves.

I do not propose any changes in transactions of this kind. Leasing finance of this sort has become an important — in many cases an essential — source of finance for investment in manufacturing industry. Under the present tax rules, however, these 100 percent allowances apply to all leased equipment.

Thus leasing effectively extends the benefits of tax incentives to certain users — such as overseas companies, certain public bodies in the U.K., and consumers — who would not qualify for tax incentives if they had purchased the equipment themselves. I propose to end these anomalies.

As from June 1 expenditure on leasing involving these users will normally qualify only for 25 percent tax allowances.

There will be transitional provisions for leased television sets. Though the extra revenue in 1980-81 will be negligible, the saving in a full year will be over £200m.

These provisions will replace, from June 1, the stopgap provision for foreign leasing which I proposed on October 23, when announcing the abolition of exchange control. They will also include measures to end the growing abuse of leasing by individuals for tax avoidance purposes.

However the Motability Scheme for leasing cars to disabled people will continue to benefit from the existing provisions.

## COMPANY LIQUIDITY

I have already referred to the difficult problems that many companies will be facing in the coming year, with great pressure on their liquidity. I have considered how far it would make sense for the Government to help them by major tax reductions.

Such help could only be provided at the expense of much higher personal taxation or higher borrowing and thus higher interest rates.

I believe that the greatest service which I can perform for business is to reduce the burden of financing the public sector and thus to get interest rates down. I have, therefore, given precedence to this objective.

However, there is, as I observed last June, a clear need to re-examine the corporate tax structure. I have already undertaken that there will be full consultations before changes are made. I understand that the accountancy profession will be publishing their new standard on current cost accounting later this month. We will, therefore, publish a Green Paper later this year, reporting the results of our general review of the present corporation tax provisions.

Meanwhile, I do not think that it would be right to change the rate of corporation tax or to make major changes in its structure. But I do propose one important concession to help companies which face a particular difficulty.

A number of businesses in manufacturing, and certain areas of distribution, are concerned about the recovery charges which they will face as a result of reductions in stock levels likely to arise either because of the general pressure on liquidity, or in some cases as a result of the steel strike.

I propose, therefore, to allow a substantial part of the stock relief recovery charge consequent on a reduction of stocks to be deferred for one year.

This change will be subject to certain conditions dependent on the extent to which stocks are financed on trade credit.

The new relief will be given for business accounts ending after 1979-80. The cost is estimated at £210m in 1980-81 and a further £125m in 1981-82.

While further relief is justified in the cases to which I have referred, there is criticism that the present stock relief may confer an unjustifiable advantage in certain circumstances.

This is a complex matter on which detailed consultation will be needed, but my intention is to legislate next year in respect of the tax payable generally on January 1, 1982. This will give enough time for consultation.

I propose another modest measure affecting business taxation. I intend to provide relief for redundancy payments in excess of the statutory minimum paid when a business stops trading.

## VAT, MINOR CHANGES ONLY

I turn now from companies to my other proposals for finding extra revenue. I begin with the indirect taxes.

Last June, I took an important step in implementing a change in the tax structure that everyone knew to be necessary. I carried out a substantial switch in the balance of taxation from direct to indirect taxes.

I do not intend to go further in that direction this year. But I do intend to ensure that the real yield of indirect taxation is not eroded. Inflation can all too easily have that effect.

First, I shall deal with Value Added Tax. Without the extra revenue from last June's Budget changes it would have been quite impossible this year for any Government to avoid either much larger cuts in public spending or big increases in income tax.

This is the first year in which the full yield of the 15 percent rate will be available. The yield will be some £12,450m in 1980-81.

I propose no change in the 15 percent standard rate of VAT. I am, however, making a number of technical changes, to ease the administrative burdens borne by small businesses — about which I shall have more to say later.

There have been signs that some large companies may have been delaying their VAT payments to the Exchequer. This must be corrected at the earliest opportunity. Customs and Excise are already taking steps, with my approval and within the existing law, to reduce the attractions of delay.

But more needs to be done. I shall, therefore, be asking the House to raise the maximum penalty for late payment. My proposal is that it should be expressed as a proportion of the tax at stake.

In practice, this will raise the penalty for only the larger companies. For them the existing maximum penalty, of £100 plus £10 a day is clearly inadequate.

I also propose to remedy an anomaly in the coverage of VAT. Lubricating and certain oils are currently zero-rated, without any real justification. We shall be laying an Order to charge them at the full rate from Thursday, May 1. This will yield an additional £12m in 1980-81 and £17m in a full year.

I want also to inform the House today of my decision on one of the options for staff savings in the Customs and Excise. Concern has been expressed by a number of my Hon. Friends and by representative business organisations at the possibility that we might withdraw the facility of monthly returns for those VAT traders who are entitled to claim repayments.

I have carefully considered representations about the effect on business cash flow, and I do not intend to pursue this option further.

### EXCISE DUTIES UP

This year most of the additional revenue I need from the indirect taxes must come from excise duties. Because they are applied to a physical quantity, the real value of their yield declines in times of inflation. A number of them have not been increased since early 1977 and many have been declining in real value over a much longer period.

Accordingly, taking the duties as a whole, I am proposing increases which will reflect the impact of the last year's inflation and keep the real yield roughly constant.

I start with the duties on alcoholic drinks and tobacco, which were last increased three years ago. I propose from midnight tonight to increase the duties on drinks by amounts which, including VAT, represent about 2p on the price of a typical pint of draught beer, 8p on a bottle of table wine and 50p on a bottle of whisky.

The tobacco duty will be raised with effect from midnight on Friday. Including VAT, the increase will represent 5p on the price of a typical packet of 20 king-size cigarettes.

There will be consequential increases for most other alcoholic drinks and tobacco products, but rather less than the full amount on pipe tobacco.

The increases on alcoholic drinks will yield £273m in 1980-81 and £288m in a full year. The tobacco increases will yield £180m in 1980-81 and £195m in a full year.

Next, betting and gaming. I do not propose any changes in the general betting duty or the pool betting duty. But the Government has been persuaded by some of the criticisms of the present duty on casinos made by the Royal Commission on Gambling.

This duty depends heavily on rateable value. It is not an equitable tax, and the more profitable casinos are seriously undertaxed.

From October 1, therefore, the present duty will be replaced by one related more closely to the profitability of casinos, and designed to produce about two-and-a-half times as much revenue in a full year.

At about the same time, the duty on bingo will be increased from 5 percent to 7.5 percent. Provision will also be made in the Finance Bill for restructuring the duty on gaming machines.

We intend to remove the duty on penny machines, and propose to increase the revenue from the very profitable jackpot machines usually found in clubs. These changes will yield £5m in 1980-81 and £20m in a full year.

### NO ABOLITION OF MOTOR VEHICLES TAXATION

I turn now to Vehicle Excise Duty. Our

## HIGHLIGHTS OF THE BUDGET PROPOSALS 1980/81

This year's Budget announced by the Chancellor of the Exchequer on March 26, 1980 includes many proposals relating to all fields of taxation. The major proposals are summarised below.

DIRECT TAXES:

**Personal income tax**

Abolition of the 25 percent rate of tax and raising of thresholds for higher bands of tax.

Raising of the main allowances by around 18 percent.

**Corporation tax**

The small company rate will fall from 42 to 40 percent.

**Petroleum revenue tax**

Rise in the rate of PRT from 60 to 70 percent.

An advance payment of the tax will be required for the chargeable period to June 30, 1981 in March 1981 at the rate of 15 percent of the previous year's liability.

**Capital taxes**

The review of capital taxes promised in last year's Budget has been made but no drastic structural changes were proposed.

**Capital transfer tax**

The threshold for CTT will be doubled to £50,000.

**Capital gains tax**

The present £1000 exemption, progressively withdrawn above a certain amount, will be replaced by a straightforward £3000 allowance.

The first £1500 of gains by trusts will be exempt.

Relief will be provided on gains from the sale of a private residence used for residential letting.

The double charge to tax on gifts — CTT and CGT — which may arise on the transfer of such gifts will be removed by allowing the CTT paid to be set off against any subsequent gain on the transfer.

predecessors announced their intention to abolish the duty on cars and other petrol-driven vehicles. They proposed to make good the revenue loss by increasing the tax on petrol.

As the House will recollect, after carefully reviewing the arguments, we decided that this was not a sensible change to make.

Even if the tax had gone, the need for a vehicle register would have remained. This is essential to the police and for vehicle control. So much of the form-filling would have continued unabated.

We decided it was much better to keep the Vehicle Excise Duty, but to achieve staff savings by streamlining its administration, along the lines which my rt. hon. friend the Minister of Transport has already proposed.

As part of this, he is announcing today that from October, four-monthly licences will be replaced by six-monthly licences. From August a stamp-saving scheme will be introduced to help motorists to budget for payment of this tax.

If the duty is to remain, we would be wrong to allow inflation to go on eroding its real value. Because of doubts about its future, the rates of this duty have remained unchanged since 1977.

I therefore make no apology for proposing increases in the duty on most vehicles of about 20 percent, and on the heaviest lorries of about 30 percent this year. As a result, the annual duty on cars will increase by £10 to £60.

The larger increase on the heaviest lorries will reflect the high road costs which they impose on the community. These changes will produce an estimated additional yield of £240m a year, but will still leave the Vehicle Excise Duty lower in real terms than after the last increase in 1977.

## INCENTIVE FOR ELECTRIC VEHICLES

I have one further small change to announce in Vehicle Excise Duty. Electric vehicles at present play only a small part in road transport. But they are much cleaner and quieter than vehicles powered by internal combustion engines, and they could bring big future energy savings.

Because I want to encourage their further development, I propose to abolish Vehicle Excise Duty on them. The cost in 1980-81 will be less than £2m.

In my Budget last June, I stated that there was a continuing case for measures that would help us to conserve oil.

## PETROL AND OTHER MOTOR FUELS

The price of petrol in the U.K. remains well below that in any other EEC country. If we are to ensure that our oil resources are not wasted, a duty increase is justified this year.

If we had decided, as the last Government had in mind, to replace VED progressively by higher petrol taxation, I should have been obliged to consider increasing the price of petrol by at least 20p a gallon. That would have been necessary simply to replace the revenue formerly provided by VED.

To match the VED increase I have announced would have taken the figure to 24p a gallon — and higher still, if the present petrol duty were itself maintained in real terms.

Since we are retaining the VED, such large increases are not needed. Instead, I shall be increasing the duty on petrol, from 6 pm tonight by the equivalent, including VAT, of 10p a gallon.

For the last three years the rate of duty on derv has been higher than that on petrol. I have decided that we can no longer justify this differential, which has borne heavily on commercial and industrial users.

Taking account of VAT, the increase in the duty on derv will be about 4p a gallon. This will mean that once again the duties on petrol and derv are the same.

These increases will yield an additional £450m from petrol and £55m from derv in 1980-81, and in a full year.

I also propose to raise the duty on heavy oil, other than derv, by about 0.5p a gallon from 6 pm tonight. This will yield an additional £50m in 1980-81 and in a full year.

I have decided not to increase the duty on burning oil and on domestic paraffin, which are the oils most commonly used in the home.

These VAT and excise duty changes will raise additional revenue of £1,260m in 1980-81 and £1,305m in a full year. They do not imply any real increase in indirect taxes as compared with 1979-80.

The immediate impact effect on the RPI will be just over 1 percent, but in the longer run these excise duty changes, by contributing to the reduction of the budget deficit, will help to ensure that inflation is brought down and stays down.

As I have explained, I do not believe I should be justified in allowing the real costs of motoring and road transport to fall, simply as a result of inflation.

But if it is right in principle for road users to face a constant fiscal burden, it would not be fair to disregard the increasing unreality of the income tax charge levied on those who are partly sheltered from rising costs because they have a company car available for private use.

The scales of benefit charged to income tax have been allowed to fall well behind any reasonable measure of true values. The present figures barely cover the current cost of tax, insurance and maintenance.

This is unfair to individuals who have to bear the full cost of car ownership, not to mention those who cannot afford to run a car at all.

I propose, therefore, to increase by some 20 percent the scale figures which are used for measuring the benefit of a company car for tax purposes. This change will be effective from April 1981.

At the same time, there will be one modest relief. The qualifying annual mileage of business use above which a reduced rate of tax is charged should be reduced from 25,000 to 18,000 miles a year. In the light of our widespread consultations last year, I believe these changes will generally be recognised as fair.

I have also been considering whether I ought to take action to charge tax on the value of petrol provided by employers for private use by their employees. This would present severe administrative problems, both for employers and for the Inland Revenue.

Even so, I shall feel bound to contemplate action next year if the provision of free petrol continues to spread at anything like its present rate.

## BENEFITS IN KIND

As the burden of income tax is reduced, I would hope to see a decline in the provision of benefits in kind. It is consistent with that view for me to impose a reasonable charge to income tax on benefits which do remain.

In that spirit, I approach one area this year which has so far escaped the eye of my predecessors. I refer to the provision for employees of items such as suits of clothing and television sets. I propose to double, from 10 percent to 20 percent, the proportion of the value of such objects taken as a measure of the annual taxable benefit.

And I shall impose an effective charge where the items concerned are subsequently acquired by the employee for less than true value. I am also taking steps to increase from 9 percent to 15 percent the rate of interest used to measure the value of beneficial loans to employees and to raise to £200 the limit below which the benefit of such loans is not charged to tax.

Fringe benefits are charged to tax only if the employee earns more than a certain amount, now £8,500. The case for abolishing this threshold has been pressed upon us. I have asked the Inland Revenue to consult employers and others about the administrative problems that might be involved in such a change.

## INCOME TAX

I now turn to my main proposals for income tax. The cuts I made last year were an important start on reducing the oppressive burden of direct taxation. At every income level, taxpayers now retain a significantly larger share of their incomes, which they are free to spend or save as they choose.

I intend to do more in the future. But at a time when output is falling and we are making further heavy cuts in public expenditure, I cannot afford to protect income-taxpayers fully from the effects of inflation. This then must be a year of consolidation.

At first sight that would suggest increases in the personal allowances which fall some way short of the rise in prices during 1979. But this would have a number of undesirable effects.

It would lower the starting point of income tax in real terms compared with a year ago. It would increase the number of taxpayers. It would narrow the gap between tax thresholds and the main social security benefits. And it would impose particularly heavy burdens on those with the smallest incomes. All those effects would be most undesirable.

## INCREASE OF DEDUCTIONS COMPENSATED BY ABOLITION OF 25 PERCENT RATE BAND

Given the limited scope available, I have considered how to avoid these consequences, I mean to do so by adopting an alternative approach. I propose to increase the main income tax allowances by 18 percent or so, which is in line with the rise in prices and in conformity with the indexation requirement of the 1977 Finance Act.

This will bring substantial relief to all taxpayers. But in order to afford this, I intend to remove the lower rate band of taxation, levied at 25 percent on the first £750 of taxable income.

This combination will protect the position of the very poorest taxpayers, whilst ensuring that basic rate taxpayers receive some, though not complete, protection from the rise in prices.

The single allowance will thus be increased by £210 to £1,375 and the married allowance by £330 to £2,145. The corresponding allowances for people over 65 will go up by £280 to £1,820, and by £440 to £2,895.

The income limit for the age allowance will go up to £5,900. Also, the additional personal allowance, available mainly to single parents, will go up by £120 to £770. The revenue cost of these increases in 1980-81 will be some £1,800m, offset by a saving of £750m from ending the lower rate band.

I cannot this year make any further reductions in the income tax rates. So the basic rate will remain at 30 percent and the higher rates will also remain unchanged.

The case for the lower rate band was never at all clear. The 25 percent rate was not the effective marginal rate for more than a small number of fulltime adult workers.

For those on lower incomes an increase in the personal allowances would always have been more valuable than the lower rate band. And the existence of this lower rate band added significantly to the complexity of the tax system.

Its disappearance will simplify and shorten the PAYE tables, and reduce the administrative burden on employers and on the Inland Revenue, where there will be a valuable staff saving of 1,300 posts.

I am in no doubt that it is right, in a year when difficult choices have to be made, to concentrate on raising the tax thresholds for everybody, as I have proposed, by about 18 percent.

I am also in no doubt that it is necessary to abate the tax reductions which follow from that change by the abolition of the lower rate band.

Taken together, these changes are equivalent to an effective increase in tax reliefs of 11 percent for a married couple and rather less than that for single taxpayers.

The 18.75 percent rise in child benefit implies a broadly comparable annual rate of increase — about 11 percent — over its April, 1979, level.

Next, higher-rate taxpayers. Given the substatial improvements last year it would not be appropriate to give major relief to higher-rate taxpayers this year.

However, our progressive income tax system operates in such a way that those who pay tax at higher rates experience sharply increasing tax burdens in times of inflation.

In the ordinary course it would be right to increase the higher rate threshold and bands by the same proportion as the increase in personal allowances. That would imply 18 percent this year.

But this year the improvements in personal allowances are partially offset by abolition of the lower rate band. That change will have only limited significance for those on higher incomes. So I have decided not to raise the higher rate thresholds fully in line with inflation, as I have done for the main personal allowances, but to put them up by only about 11 percent.

That is, as I have explained, broadly equivalent to the total net increase in tax reliefs which I have proposed for married couples paying tax at the basic rate.

In money terms the threshold for the higher rates will be raised to £11,250 and the threshold to the top rate of 60 percent to £27,750. There will be corresponding increases at the intervening points.

So far from making the rich richer, these restricted improvements will result in an increase in the real burden of income tax for the higher rate taxpayer.

The cost of increasing the higher rate thresholds is £100m in 1980-81 compared with a cost of £140m if they had been fully indexed.

I am also limiting this year's increase in the threshold to the investment income surcharge to 10 percent, that is to £5,500. However, with a view to consistent treatment in future years, I shall include provisions in the Finance Bill which should ensure, with effect from next year, that the higher rate threshold and bands, together with the investment income surcharge threshold, are covered by indexing legislation in the same way as the main personal allowances.

For the typical married couple with two children the net effect of my Budget changes will be to increase their weekly income by £2.68 per week from November. For a single man with the same earnings the increase will be 49p per week.

The income tax changes I am proposing will be given effect when new tax tables have been printed and distributed. They will be made together and will produce a net increase in take-home pay on the first pay day after May 31.

## AWARDS

I am proposing two other small income tax changes which have long merited action.

I propose to exempt from tax the payments made to holders of certain gallantry awards, such as the Distinguished Conduct Medal and the Conspicuous Gallantry Medal. These will in future be treated in the same way as annuities payable to holders of the Victoria Cross and George Cross.

I went also to do something more for widows in the difficult time immediately following bereavement. I therefore propose to increase the present single allowance which widows receive for the tax year in which they are bereaved.

The addition for that year will, at its maximum, bring the single allowance for widows up to the level of the married allowance.

We have also been reviewing the treatment for tax purposes of husband and wife. This is a complex and important subject. I am grateful in particular to the Equal Opportunities Commission for the light which their publications have shed on this aspect of sex discrimination.

It is easier to define the problems than to find the answers. Certainly, radical changes should not be made in haste. I propose, therefore, to issue later this year a Green Paper on this subject. I hope that it will stimulate further constructive debate, leading us ultimately to acceptable solutions.

Although, as I have just explained, this is not a year in which sweeping reductions of income tax are possible, that need not prevent us making sensible reforms in the tax system wherever the opportunity offers.

I have frequently drawn attention to the extent to which the tax system has woven itself deeply into the fabric of national life. Tax has been piled upon tax, often with little regard for their interaction. The accidental effects of this tax onslaught have often been as damaging as the direct consequences.

## HOUSING

My first proposal is designed to help first-time buyers in particular.

I have received representations from many quarters about the burden of stamp duty on house purchasers. Difficulty in acquiring a new home restricts the mobility of labour. Those at the lower end of the market — mainly young couples — particularly deserve help.

I do not think these considerations justify us in making, this year, an increase in the mortgage interest relief ceiling, which I propose to maintain at £25,000. But I do think it would be right to raise the starting point for stamp duty on transfers of property by £5,000 to £20,000.

The limits for reduced rate bands will be similarly increased, by £5,000, so that the full 2 percent rate will now be reached at £35,000. This will cost £75m in 1980-81, and £85m in a full year.

Too many homes are underoccupied, or even standing empty. This is often a direct, even if unintended, result of rent control: sometimes it is a consequence of planning policies, which my rt. hon. friend the Secretary of State for the Environment is improving.

There are also fiscal obstacles to the economic use of the available stock of property. One of those I intend to deal with this year. I propose a new and additional relief from capital gains tax to help people who let part of their homes.

At present these house-owners, when they come to sell, can find themselves unexpectedly faced with a capital gains tax charge. This change will encourage letting, and contribute to the better use of the housing stock.

Next, the national heritage. The House has already passed a Bill to set up the National Heritage Fund. The Finance Bill will include a provision to treat if for tax purposes as if it were a charity.

The Fund will be set up with an initial amount of around £12m at its disposal. The Government will in future make an annual contribution to the Fund, including the amount needed for the continuation of the acceptance in lieu system.

But we should also do more to make it possible, both today and in the future, for owners of historic houses to look after their properties on behalf of the nation as a whole.

The last Government took a similar view and introduced provisions to assist owners to set up maintenance funds for the support of their houses. But that scheme proved to be so restrictive that it has hardly been used.

I intend therefore, to recast substantially the maintenance fund provisions. If we are going to adopt this method of encouraging the preservation of our heritage — and I believe it is the right one — then it is only sensible to make it work.

Our fresh proposals will apply to the maintenance of buildings, historically associated contents, gardens, and land of historic, scenic and scientific interest.

The overriding condition will, of course, be that the public should have reasonable access. These measures are intended to cement a bargain between those who have to bear the cost of maintaining the National Heritage, and the people as a whole.

## CHARITIES

The third way in which we aim to assist private action this year is by providing tangible Government support for the widespread and often unsung voluntary effort that goes on at every level of our national life.

It is important to do all we can to help charities and to stimulate private benefactors and helpers. A partnership between Government and voluntary effort can be the best way of meeting many pressing social needs, particularly when State spending is having to be cut back. With this in mind, I have given careful consideration to the fiscal recommendations of the Goodman Committee and of the National Council of Social Service.

I propose to double — to £200,000 — the capital transfer tax exemption for bequests to charities; and to exempt wholly from development land tax all future disposals of land by charities. Income tax relief for payments to charities made under Deeds of Covenant, which has hitherto been limited to the basic rate of income tax, will be extended to the higher rates subject to a ceiling of £3,000 a year.

A minor stamp duty easement on Deeds will be made. And in response to representations I am reducing the period for tax relief on Deeds of Covenant from seven years to four years.

These measures, which will cost £30m in a full year, are designed to provide the right conditions for substantial growth in the important partnership between voluntary service and the community.

## EQUITY INVESTMENT

Now I turn to an area where the tax system can be used to involve the individual more closely in the working of the economy. I refer to proposals which will encourage direct personal investment in the stocks and shares of British industry.

In the last 20 years the proportion of the equity of British companies held in direct individual ownership has been almost halved. This is a trend I should like to reverse.

It is generally agreed that share-ownership and profit-sharing can help in developing employees' understanding of, and commitment to, business and industry. I believe that share-ownership can also spread a wider understanding of the role for risk-taking and initiative in the economic system.

I have two sets of proposals to make.

First, I propose to make more generous the provisions which the last Government introduced two years ago to encourage profit-sharing.

In passing, I would note that those provisions were based upon proposals originally put forward by my rt. hon. friend, the Secretary of State for Energy. They attracted all-party support.

I propose to raise from £500 to £1,000 a year the value of shares allocated to any one employee which can qualify for tax relief; to reduce from five years to two the period after which employees can sell their shares; and to cut from 10 years to seven the period after which they can draw them out free of income tax.

Second, I propose to reintroduce legislation similar to that which Lord Barber introduced in 1973 enabling employees to be given options to buy shares in their companies without incurring liability to income tax.

This scheme will have links, as in 1973, to a scheme for contractual savings. These measures will help to fulfil our promise to encourage employee share-ownership and provide the incentive to save and build up capital.

There is one anomaly in the field of life insurance, which I propose to put right.

The rate of life insurance relief used to be equivalent to half the basic rate of income tax. It has recently got out of line and I propose to restore the relationship by reducing it to 15 percent.

Because of the practical problems posed for the life insurance industry, the change will not take effect until April 6 next year.

Steps will also be taken to deny life assurance premium relief to certain short-term bonds. This change will take effect from today.

Before I leave discussion of the capital markets I should add that I propose that traded options, which at present are anomalously treated as wasting assets for Capital Gains Tax purposes, should in future be treated on the same basis as share warrants.

I hope these measures will help to encourage the wider direct ownership of shares, by altering the relative attractions of investment through the institutions and through more direct means.

I come now to a series of measures which are intended to increase the wealth-creating vitality of our economy. That means giving greater encouragement to the processes of economic change, and improving incentives to the enterprise sector. For the mainspring of economic vitality it is now widely agreed that we must look to private initiative, widely dispersed and properly rewarded. Enterprise means jobs.

## TAXATION OF CAPITAL

I start with capital taxation, which is widely regarded, and rightly so, as a severe discouragement to those seeking to build up a business and pass it on to the next generation. We have, as I promised last year, subjected capital taxation to a thorough review.

Representations from a large number of bodies have confirmed that the damage done by these taxes in their present form is out of all proportion to their yield. There is, of course, a place for capital taxation, including in particular a charge on death. But change is needed.

What I can do this year must be constrained by our financial position. I am, therefore, proposing changes which will be of particular help to smaller businesses. This is an earnest [proof] of our determination to make further progress when economic conditions permit.

First, the march of inflation over the years has brought far too many estates into charge to the capital transfer tax. This is a particular burden on the small business, when it passes from one generation to another, whether on death or by lifetime transfer.

I propose therefore that the threshold for the capital transfer tax should be increased to £50,000. This will exempt from the tax at least two-thirds of the estates which would otherwise have been liable; and up to 400 fewer staff will be needed than if we had left the threshold unchanged.

A reduction in the scale of rates above the new threshold, however much it is needed, is not possible at the moment; nor are other changes I should like to have made. I am, however, making one or two minor changes designed to reduce administration.

In the case of the capital gains tax, I am fully conscious of the impact inflation has had. It can rightly be argued that the tax often falls on what are no more than paper gains. Proposals for indexation or tapering as a means of meeting this problem have been put forward on many occasions in the past.

I have had both proposals re-examined but the conclusion to which I have come is that both would result in an unwelcome increase in the cost of administration — for taxpayers as well as the revenue — while reducing the yield of the tax to negligible proportions.

I cannot, however, leave matters as they are, I propose, therefore, to replace the present £1,000 exemption — which is progressively withdrawn above £5,000 — by a straight forward allowance of £3,000.

This change, which will operate from April 6, will remove from tax half the cases at present liable; and at a reasonable revenue cost, it will reduce staff requirements by 300.

As a corollary of this new proposal, there will be an exemption for the first £1,500 of gains for trusts: and investment and unit trusts will now be exempted from the tax, although investors in such trusts will remain liable if their own gains in the year exceed the new exemption limit.

Finally, I propose to remove the present double charge on gifts, which arises from the overlap between Capital Transfer Tax and Capital Gains Tax, by providing roll-over relief for the latter. This has been a particular source of grievance and one on which representations have been received from a large number of people.

The cost of these changes in the Capital Transfer Tax will be £60m this coming year and twice as much in 1981-82.

In the case of Capital Gains Tax, there will be no cost this coming year and a cost of £25m in 1981-82. These figures need to be judged against the already rising yield of the capital taxes as a result of inflation.

I realise that these necessarily limited changes will fall short of what many people had hoped for. But I must ask for patience in present circumstances. Meanwhile the benefit the present changes give to the small business should not be under-estimated.

Because of the 50 percent relief — which will remain, as will the comparable relief for agriculture — a person transferring a business worth £100,000 will pay no Capital Transfer Tax, if there are no other assets.

We would, of course, have liked to bring similar help to businesses of all sizes. My proposals do give some measure of relief to everybody, but this year most assistance goes to small businesses. As I have already indicated there have been extensive consultations on Capital Taxation before the Budget. We propose to continue this process. There are in particular certain speciialised areas such as settled property which require every detailed consideration.

I now turn to another tax which can inhibit development, the Development Land Tax. In my last Budget I reduced the rate of this tax to 60 percent and increased the exempt slice to £50,000. I then said there would be no further reduction in the rate and no early increase in the exempt slice. This remains the position.

Representations have, however, been made to me from many quarters that the tax inhibits development because of uncertainty about the amount of tax chargeable which can normally only be ascertained once development starts.

It is important to remove obstacles of this kind if we are to make the best use of our resources. I propose to deal with this point and the necessary legislation will be added to the Finance Bill at an appropriate stage. There will also be a number of other detailed improvements. All these changes are designed to free the market and encourage development.

Taxes are stifling independent enterprise in other ways too.

## SMALL BUSINESSES

For many years the fashion both in Government and in industry was to favour mergers and amalgamations. No doubt mergers have brought advantages in some cases. But it is now clear that the fashion for industrial elephantism was greatly exaggerated.

I believe that there are cases where businesses are grouped together inefficiently under a single company umbrella. They could, in practice, be run more dynamically and effectively if they could be "demerged" and allowed to pursue their own separate ways under independent management.

The present tax rules can in practice effectively discourage demergers of this kind, by charging the assets of the "demerged" company to advance corporation tax and income tax as distributions.

I propose to bring forward, during the passage of the Finance Bill, measures to ease the tax charge on distributions of this kind, subject to certain safeguards and where they are concerned solely with the genuine splitting off of independent trades within the corporate sector.

My colleagues and I would welcome any views those outside Government might have on these proposals. It may be that further measures will turn out to be justified.

I now turn to measures specifically designed to improve the tax environment in which the small business lives and works.

Any business, but particularly the new small business just starting up, needs somewhere to operate.

An imaginative and helpful new venture in recent years has been the development of estates of small industrial workshops for separate letting to small businesses.

I propose to bring in a Small Workshops Scheme which will enable industrial buildings allowances at the rate of 100 percent to be claimed on the construction of small industrial buildings. The scheme will run for three years, and will simplify the present administrative arrangements.

I shall also make provision for industrial buildings allowance to be given on the construction of industrial buildings rather than on their first lettings.

In addition to my own proposals, my right honourable friend the Secretary of State for the Environment intends to consult on relaxation of planning controls over changes of use as between light industry and warehousing for small units.

My right honourable friend the Secretary of State for Industry intends to make £5m available to build 1,000 new nursery factory units in assisted areas in co-operation with the private sector.

New businesses and particularly new small businesses also need capital. Many people with capital to invest might be ready to back enterprising ventures if they knew that losses could be offset against taxed income, instead of only against capital gains.

I propose that, through a new Venture Capital Scheme, losses on equity investment in unquoted trading companies, incurred after April 5, 1980, may be set off against income.

Next, I propose to relax the conditions for tax relief for interest paid on money borrowed for investment in, or lending to, a close company. The present rules require an investor to have worked for the greater part of his time in the company's business. I propose to abolish that condition, and thus provide added incentive for outside investment in small firms.

Just as important as attracting new capital from the outside is the generation of new capital from the inside, in the form of profits which are retained in the business.

The tax system has now contained for over 50 years a series of provisions under which a "close" company may be required to justify the amount of profits which it wished to retain in the business, undistributed.

Following last year's reduction in the rate of income tax, I now propose important changes including the abolition of the apportionment of trading income both of close trading companies and of members of trading groups.

These changes will cut out a thicket of complex tax provisions, which are time-consuming for the small trading business, and a real impediment to growth.

But if small companies are to generate the funds to finance their expansion, they must first earn profits and then they must be left with sufficient of those profits after payment of tax.

Better profits must come through improved efficiency and greater productivity. That is a matter for industry itself and not for Government. But Government can help by reducing the burden of tax.

I propose therefore to cut the small companies' rate of corporation tax to 40 percent — that is no less than 12 points below the full rate of 52 percent — and at the same time to raise the qualifying limits to £70,000 for the full relief and £130,000 for the marginal relief.

My next proposal is designed to help the unincorporated small business. It is important that the self-employed should be able, with tax assistance, to make adequate provision for their retirement.

## PENSIONS

I am therefore raising the limits on retirement annuity relief. The normal percentage of earnings qualifying for tax relief will go up from 15 percent to 17.5 percent, and the ceiling on the premiums qualifying for relief will be abolished.

## BUSINESS LOANS

I also propose some minor measures affecting business taxation. Following consultations with industry I propose that the costs of raising business loan finance should be allowed for tax purposes; relief will also be given for pre-trading expenses of a business provided these expenses would have been allowable if the business had been trading when they were incurred.

Certain changes will also be made in the tax deduction scheme for the construction industry — the 714 scheme — which will lighten the administrative burden of the scheme and change certain features which operate harshly.

As the last element in my package to help small businesses, I am making certain changes in the arrangements for VAT, in order to ease the administrative burden.

I propose that from midnight the registration threshold for VAT should be increased from £10,000 to £13,500. The de-registration limit will also be increased from June 1. At the same time I shall be increasing from £50 to £250 the relief from payment of tax on stocks and assets when a person de-registers.

## ENTERPRISE ZONES

Despite the severe financial restrictions we are thus giving help to smaller businesses at many, many points where the system bears too hardly. Individually relatively few of the measures could be described as of major importance; but taken together they represent a significant step forward in making this country one in which enterprise will be properly rewarded and thus flourish again. Together they will cost about £160m in a full year.

Finally, I come to an idea that is intended to pioneer a new and more adventurous approach to the whole question of industrial and commercial renewal.

There are some parts of our economy, most notably in the older urban areas, where more and more public authority involvement seems to have led to less and less fruitful activity.

The planning process has all to often allowed, even caused, whole areas at the heart of some of our most populous cities to be laid to waste for years, even decades.

Even when plans do finally come to be made, the public purse is often unable to provide the funds, or the enterprise, to match the planners' aspirations. And when private initiative might have been ready to stir, it has generally been stifled by rules and regulations — and by a tax system which pays no regard to these special problems.

Some hon. Members may recall that, in a speech made on the Isle of Dogs, a little less than two years ago, I put forward a proposal for trying to bring new life back to these areas of urban dereliction.

The idea was not politically partisan. For my thinking had taken place in parallel with that of the distinguished Fabian, Professor Peter Hall. Quite independently, we had concluded that there was much to be said for the establishment in these man-made wildernesses of what I have called "Enterprise Zones".

I am, therefore, pleased to be able to announce today action by the Government which will transform into reality the idea which I then put forward.

We are proposing to establish, in the first instance, about half a dozen Enterprise Zones — with the intention that each of them should be developed with as much freedom as possible for those who work there to make profits and to create jobs.

Each will cover perhaps 500 acres. Within these Zones two major tax incentives will be available; first, 100 percent capital allowances for both industrial and commercial buildings; and, second, complete relief from development land tax.

But fiscal concessions are only part of what is needed.

These Zones will, therefore, enjoy the following additional benefits: 100 percent derating of industrial and commercial property; a drastically simplified planning scheme; exemption from the scope of industrial training boards (with consequent exemption from industrial training levies); accelerated handling of applications for warehousing free of customs duty; minimal requests from Government for statistical information; and abolition of the remaining industrial development certificate procedures.

I hope and believe that an imaginative experiment along these lines may succeed where conventional policies have proved inadequate. No one can doubt the need for change from present arrangements.

In far too many of our towns and cities today, and for far too many businesses, particularly small and new ones, the gap between a productive idea and a foreseeable profit has widened into a chasm of red tape. And the same red tape all too often stands between a young school leaver and the prospect of a job.

Even before this proposal had any official status at all, there has been no lack of interest in the idea. The Government will be consulting local authorities and other interests before decisions on individual areas are made. Fuller details will be found in the policy document, which is being issued this evening. There could not be a better time for making a fresh start of this kind.

For in the decade that lies ahead. Britain has the opportunity of following a more hopeful path. We have ended the 1970s with a society that is becoming less tolerant, because we live with an economy that has been growing no richer. The 1980s can be very different.

The disappointments of the last decate spring from illusions that have persisted too long; the illusion that we can pay ourselves what we have not earned; the illusion that governments may go on borrowing when they dare not tax; and, most foolish of all, the illusion that we can somehow strike our way to higher living standards.

**Married couples – income all earned**

| Charge for 1979/80 | | | Proposed charge for 1980/81 | | |
|---|---|---|---|---|---|
| *Income* | *Income tax* | *Percentage of total income taken in tax* | *Income tax* | *Percentage of total income taken in tax* | *Reduction in tax after proposed changes* |
| 2,000 | 46 | 2.3 | 0 | 0 | 46 |
| 2,500 | 171 | 6.8 | 106 | 4.3 | 65 |
| 3,000 | 317 | 10.6 | 256 | 8.5 | 61 |
| 3,500 | 467 | 13.4 | 406 | 11.6 | 61 |
| 4,000 | 617 | 15.4 | 556 | 13.9 | 61 |
| 4,500 | 767 | 17.1 | 706 | 15.7 | 61 |
| 5,000 | 917 | 18.4 | 856 | 17.1 | 61 |
| 6,000 | 1,217 | 20.3 | 1,156 | 19.3 | 61 |
| 7,000 | 1,517 | 21.7 | 1,456 | 20.8 | 61 |
| 8,000 | 1,817 | 22.7 | 1,756 | 22.0 | 61 |
| 9,000 | 2,117 | 23.5 | 2,056 | 22.8 | 61 |
| 10,000 | 2,417 | 24.2 | 2,356 | 23.6 | 61 |
| 12,000 | 3,036 | 25.3 | 2,956 | 24.6 | 80 |
| 15,000 | 4,296 | 28.5 | 4,017 | 26.8 | 279 |
| 20,000 | 6,704 | 33.5 | 6,302 | 31.5 | 402 |
| 25,000 | 9,364 | 37.5 | 8,833 | 35.3 | 531 |
| 30,000 | 12,273 | 40.9 | 11,588 | 38.6 | 685 |

Nothing will be easy in the years immediately ahead. But beyond that the strategy offers hope of real success.

It is a strategy for the defeat of inflation, by the re-establishment of monetary control. It is a strategy for the restoration of prosperity, by the encouragement of enterprise.

Politics is not only the art of the possible, it is also the art of the necessary. The strategy outlined in this Budget is designed to do what is necessary — and so lay foundations for the success which is well within the grasp of the British people.

## RESTORATION OF PROSPERITY BY THE ENCOURAGEMENT OF ENTERPRISE

The essential condition for success in the 1980s is that we should turn our backs on those illusions that we should have the courage, over a period of years, to carry through the realistic policies to which there is no alternative.

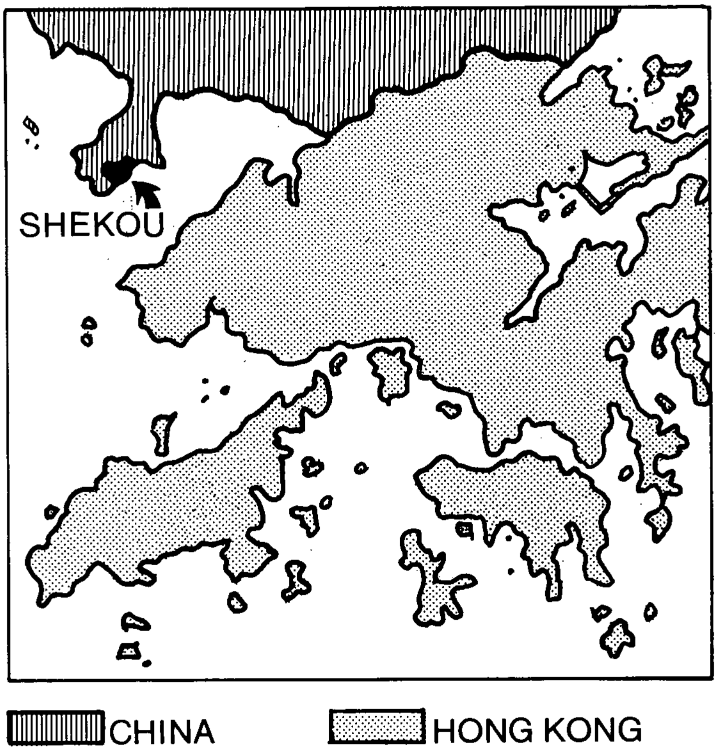
In this Budget I have tried to set those policies in a strategy for the medium term.

### ERRATUM

*In the box accompanying Mr. Paulo Kantor's article "The Supplementary Income Tax (Imposto Suplementar de Renda) on Dividend Distributions" it was erroneously stated that corporations opting for consolidated returns are subject to a 32 percent rate of corporate income tax. This 32 percent rate was abolished by the Decree Law No. 1,648 of December 18, 1978. We wish to emphasize that the mistake was made by the Editors and that Mr. Kantor is not responsible for the contents of the box.*

# FIRST INDUSTRIAL ZONE IN CHINA ESTABLISHED*

Development of an area in Shekou district (SKIZ)




The State Council of the People's Republic of China recently authorized the China Merchants Steam Navigation Co., Ltd. of Hong Kong (hereinafter "CMSN") to develop the Shekou district into an industrial zone. In the initial stage, the area comprises some 10,000 sq.ft.; the administrative supervision lies in the hands of Shenzhen City of Guandong Province.

The major role to be played by CMSN is to attract foreign entrepreneurs, overseas Chinese as well as residents of Hong Kong and Macao to participate in joint ventures in the Shekou Industrial Zone. The main field of activity in that zone is to engage in manufacturing and processing commodities, the bulk of which is to be exported. The Joint Venture Law of the People's Republic of China [1] will govern these joint ventures. Also they must be incorporated and registered with the Administration Bureau of Industry and Commerce in Shenzhen, notwithstanding the fact that negotiations usually occur in Hong Kong.

The CMSN has published an Investor's Handbook entitled *The Shekou Industrial Zone in Shenzhen.* It deals with questions including geographical location, weather and climate, earth conditions, construction work and the particulars of joint ventures in SKIZ. Reproduced below are those sections which relate to questions of location, investment and taxation.

The sections dealing with taxation refer specifically to:
(a) *import tax;*
(b) *export tax*; and
(c) *Corporation Profit Tax.*

Apparently, the term *import tax* is used to combine the Industrial and Commercial Consolidated Tax and import duties. The Industrial and Commercial Consolidated Tax is basically a sales (turnover) tax which has, in certain respects, the features of an excise duty. The rates vary from 1.5 to 69 percent. The amount generally reflects the degree of necessity of a particular item to the economy and/or to the average consumer. No credit is given for tax previously paid, a sharp contrast with the value added tax found throughout European countries. [2] The tariff for import duties is classified into 17 categories which consist of 1864 items. The rates vary considerably and may approach 400 percent (e.g. tobacco). [3]

*Export tax* apparently also refers to the Industrial and Consolidated Tax but further includes export duties. Significantly, export duties are levied on a very limited number of items. [4]

In any case, the International Bureau of Fiscal Documentation was informed by the competent authority that "all supplies furnished to SKIZ ranging from equipment, construction materials, raw materials to daily necessities *shall be imported free of tax* and finished and semi-finished export products manufactured in SKIZ *shall be exported free of tax*".

*Corporation Profit Tax* will be levied on a joint venture's income after a 3-5 year tax holiday. No details are yet known explaining whether provisions concerning the computation of profits, etc. will generally correspond with those applied for purposes of the Industrial and Commercial Income Tax, or whether new legislation will be promulgated in this field. [5] Readers are kindly advised to follow developments as revealed in our publication TAX NEWS SERVICE.

* The editors would like to express their sincere thanks to China Merchants Steam Navigation Co. Ltd. of Hong Kong (CMSN) for the permission to reproduce parts of its Investor's Handbook *The Shekou Industrial Zone in Shenzhen.*

1. For a detailed discussion of the Joint Venture Law of the People's Republic of China and a reprint of the full text of that law in English, French and German, see the loose-leaf publication: TAXES AND INVESTMENT IN ASIA AND THE PACIFIC, Chapter on the People's Republic of China, published by: International Bureau of Fiscal Documentation, Amsterdam.
2. For a detailed discussion of the Industrial and Commercial Consolidated Tax including a complete list of tax rates, see the publication mentioned supra.
3. For more details, see the publication mentioned supra. Furthermore, the *Deutsche Handelsarchiv* has published a complete list (in German) in its publication: DHA 1973 Heft 9 at 1103 ff.
4. Id. at 3.
5. For a detailed discussion of the Industrial and Commercial Income Tax, see supra, note 1.

## Geographical location

"The Shekou Industrial Zone" (SKIZ) is located on the east coast of the Pearl River estuary, just to the west of the city of Shenzhen and embraced by the Deep Bay. SKIZ is in an advantageous location where sea and land transportations are convenient — separated only by the water of the bay from Yuen Long and Lau Fau Shan of the New Territories; about 30 kilometres from Shenzhen and about 150 kilometres from Guangzhou by road; around 20 nautical miles from the Central of Hong Kong and around 80 nautical miles from Guangzhou by sea.

The superiority of SKIZ in geographical location makes it an ideal place for foreign businessmen, overseas Chinese and compatriots from Hong Kong and Macao to make industrial investment.

## Particulars of joint ventures in SKIZ:

1. *Equity ratio:*
The partners of a joint venture shall make investments in cash according to their respective percentage of share-holding in the venture. Each partner's investment shall in general not be less than 25 percent of the total investment. The exact proportion of share-holdings in a joint venture may be agreed upon between the parties according to the particular line of business of the venture. Technological patents and equipment may be converted into cash as investment.

2. *Organization:*
A joint venture shall have a Board of Directors, a president and various department managers. The Chairman of the Board of Directors shall be appointed by CMSN; the Vice-Chairman, the President, the Vice-President as well as department managers shall be appointed through consultation by the participants.
With regard to the Memorandum & Articles of Association of a joint venture, reference may be made to both Hong Kong and international conventional practices.

3. *Contract period:*
The contract period of a joint venture shall be determined by the particular line of business of the venture. The average term is around 25 years. The period may be extended upon expiration through agreement between the parties. Any application for such extension shall be made six months before the expiration of the contract.

4. *Land and land utility cost:*
The Real Estate Company of the Shekou Industrial Zone, a subsidiary of CMSN, has been authorized to plan and control the use of the land of the district.
Joint ventures shall apply to the Real Estate Company of SKIZ for the use of land there and pay its utility in compliance with the rules concerned.
The land utility cost is HK$2 to HK$4 per sq.ft. per year.

5. *Taxes:*
All supplies furnished to SKIZ ranging from equipment, construction materials, raw materials to daily necessities shall be exempted from import tax.
Finished and semi-finished export products shall be exempted from export tax. But taxes shall be levied on products for the domestic market in accordance with Customs' regulations of the PRC.
A joint venture shall qualify for a 3-5 year tax holiday from the date of its commissioning. From the 4th or 6th year on, a 10 percent Corporation Profit Tax shall apply.

6. *Visa application:*
Foreign residents, overseas Chinese and compatriots from Hong Kong and Macao entering SKIZ by sea may have their passports or travel documents visaed at the wharf of the Zone.
Compatriots from Hong Kong and Macao entering SKIZ by road via Shenzhen shall go through visa formalities in accordance with the usual practice.
Foreign nationals, foreign nationals of Chinese descent and overseas Chinese entering SKIZ by road via Shenzhen may present their passports or travel documents two days in advance to the Planning and Development Division of CMSN, which will obtain the required visas for them.
Those who wish to make a one day trip to the place shall be granted entry-exit visas valid for one day; technical and management personnel who have to frequent the Zone to perform their duties shall be granted 3 or 6 month multiple entry-exit visas.

7. *Staff and workers:*
A joint venture shall present a list of manpower requirement covering the numbers and qualifications of workers, technicians and administration personnel needed in the venture to the Labour Services Company of the Shekou Industrial Zone, which shall in turn recommend to the joint venture suitable candidates they could possibly find.
The joint venture has the right to scrutinize the candidates. If the candidates prove to be satisfactory, employment contracts shall be concluded between the joint venture and the Labour Services Company of the Shekou Industrial Zone.
The joint venture also has the right to dismiss any workers or staff members who seriously violate the rules and regulations of the venture during the execution of the employment contracts.

8. *Salaries, wages and welfare funds:*
A joint venture shall pay the workers in Hong Kong dollars which shall be converted into Renminbi. The average wages for ordinary workers of a joint venture shall be higher than those for workers working in the same kind of enterprise of China and lower than those for workers working in the same kind of enterprise of Hong Kong. A joint venture shall appropriate a certain sum of money equivalent to 10 percent of the total amount of wages as welfare funds and medical benefits for the workers. A bonus shall be given to workers and staff members who have fulfilled or overfulfilled their production quotas with products up to the standard both in quality and in quantity.
The staff and workers of a joint venture in SKIZ shall enjoy the statute holidays, festivals and leave days with full pay in line with the laws of the People's Republic of China. Staff and workers on sick leave shall get

their pay in accordance with the pertinent regulations of the PRC.
Labour insurance for workers and staff members shall be effected with the insurance company in SKIZ by the joint venture.
Salaries and benefits for senior technicians and management personnel shall be fixed separately.
Salaries for technicians and management personnel from abroad as well as from Hong Kong shall also be fixed separately. The foreign and Hong Kong staff shall pay a certain sum of personal income tax.

9. *Foreign exchange control:*
Foreign currency shall be used in book-keeping/accounts of the joint ventures in SKIZ. Every joint venture should submit to the General Administration of the Shekou Industrial Zone its quarterly balance sheets. Foreign exchange transactions shall be conducted at the banks in SKIZ. Foreign currencies can be freely remitted both inwards and outwards but through the banks in SKIZ only.

10. *Power and water supply:*
Power consumption in SKIZ shall be charged at the same rates as applied in Hong Kong for industrial electricity. Water consumption shall be charged by the unit (1,000 gallons of water is calculated as one unit.) and at a rate 20 percent lower than that applied in Hong Kong.

11. *Arbitration:*
In case of economic or legal disputes, the parties involved shall endeavour to settle them through friendly consultation. Should consultation be exhausted, the disputes may be settled through conciliation or arbitration by an artbitral body of China or through arbitration by an arbitral body agreed upon by the parties.

For further information, please contact

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Telex: 75326 CMSN HX
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## CHINA: LEGAL COUNSEL OFFICE
### Now set up in China Council for the Promotion of International Trade (CCPIT)

*Along with the development of China's foreign economic and trade relations, inquiries from industrialists, businessmen as well as lawyers and practitioners abroad about the relevant legal matters are pouring in. At the same time, requests of the parties concerned for consultation or for the recommendation of legal agent to act on their behalf in negotiation, conciliation, arbitration or legal proceedings in respect of their economic, commercial and maritime disputes with their respective foreign or Chinese counterparts are growing in number. In these circumstances, the China Council for the Promotion of International Trade has decided to set up a Legal Counsel Office which can deal with the following matters:*

1. *To act as agent in litigation and arbitration cases having to do with economic, commercial and maritime disputes between foreign and Chinese counterparts, as entrusted by clients at home and abroad;*

2. *To assist in resolving economic, commercial and maritime disputes between foreign or Chinese counterparts, as entrusted by clients at home and abroad;*

3. *For consultation on questions relating to economic, commercial and maritime laws and practices.*

*The Legal Counsel Office will charge reasonable fees for services in accordance with work done, efforts made and actual costs to be borne by the clients.*

*Address:* China Council for the Promotion of International Trade
4, Taipingqiao Street, Beijing, China
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**CORRIGENDUM**

*The country bordering the North and Mid-East of Ethiopia shown in the map on page 4 of the January issue of the Bulletin should read the Republic of Djibouti. Moreover, the administrative region of Ethiopia bordering Shoa, Hararge, Bale and Sidamo is Arsi.*

# The GATT Multilateral Trade Negotiations – Principal Results

*Information Note prepared by the Commission of the European Communities (November 1979) on the occasion of the agreement given by the Council of Ministers on 20 November 1979 to the results of the Multilateral Trade Negotiations undertaken in the framework of the GATT.*

**Contents**



## I. RESULTS WHICH EXCEED APPEARANCES

The multilateral trade negotiations (MTN) — known as the "Tokyo Round" because the decision to initiate them had been taken in the Japanese capital in September 1973 by 103 nations of the world — ended on April 1979 with a general agreement on the essential points. Their goal was to reduce obstacles to trade in the world, and the most spectacular element is, to all appearances, the lowering of customs duties which will go into force at the beginning of 1980.

Nevertheless, without wishing to minimize the importance of this aspect, the results of the MTN far exceed the simple fact that in the future, duties will be lowered; basically speaking:

— *a new discipline in international exchanges has been instituted*

Between industrialized countries, customs duties — with the exception of "peaks" remaining in a few customs tariffs — had as obstacles to trade become almost secondary as compared to the regulations and restrictions of customs valuations, of technical standards, subsidies, compensation rights, and protectionism in national markets. The MTN have helped to define (with one exception, the safeguard clause) new codes and other legal texts on these various aspects which should if not eliminate, at least reduce abuses and disguised protectionism and pave the way for a freer and more harmonious development in international exchanges.

— *International trade for agricultural products will be considerably improved and facilitated*, by taking into consideration the special aspects of this sector. Prior to the Tokyo Round two major gaps (among several others) existed in the organization of worldwide agricultural exchanges: the United States benefited from a dispensation which allowed it not to respect all the GATT rules and for example to apply a surcharge on imports of subsidized products without taking into account GATT's clear-cut regulations in this sector; the common agricultural policy (CAP) of the European Community was in certain of its aspects, the object of recurring disputes aimed at challenging its legitimacy.

This situation has been modified by negotiation: the United States will, at present, accept greater international discipline; and the specific mechanisms of the CAP will no longer be contested as to their basic principle, their application being — as in the past — subject to GATT regulations.

In addition, systems for permanent consultation have been introduced into the agricultural sector, in order to supervise the stabilization of world markets in view of the special responsibility of this sector in the solution to such problems as hunger in the world and the chronic malnutrition of entire populations.

## II. PROTECTIONISM AND THE "WORLD CRISIS" HELD IN CHECK

The results of the Tokyo Round are all the more significant that they were achieved in a period of international economic recession. In periods of expansion, it is relatively easy to reduce obstacles to exchanges as imports do not contribute to fear of unemployment or the failure of local business enterprises. The situation is quite different in times of recession when the "protectionist reflex" comes into play with the illusion that it is possible to solve problems by transferring them to others and by closing one's borders. The multilateral trade negotiations largely contributed to reducing this danger: conscious of their interdependence and their responsibilities, the leading countries or world trade-groups — headed by the Community — turned their backs on protectionism which could easily have taken hold and which, in case of failure of the negotiations, would have plunged them into a situation more severe than that of the 30's. The Vice-President of the European Commission, Mr. *Haferkamp*, had declared that in the event of a world trade war, the number of unemployed in the Community could have exceeded 10 million: social and political tensions would have become such that the structures of European society would undoubtedly not have resisted.

Naturally, to hold protectionism in check it would not be sufficient to suppress the barriers to exchanges without criteria, guidelines or precautions. The guidelines constitute the "rules of the game". They are the codes and procedures already mentioned. The criteria concern, for example, the special advantages granted the weaker nations, that is to say, the developing nations, from whom the industrialized nations expect only partial reciprocity and in some cases none at all. Precautions refer essentially to the balancing of reciprocal concessions. After several years of efforts, the European Commission, which conducted negotiations on behalf of the Community, on the advice of the Council of Ministers and in permanent contact with the Committee of Representatives of the Member States (Committee known as the Article 113 Committee), has considered that the overall results are "reasonable, well-balanced and acceptable". From the European Community's point of view, the results are far from negligeable: goals have not all been achieved, but in a few fields they have even been exceeded; in return for certain concessions, the European Community has improved its access to the American market, and, to a lesser degree, to the Japanese market and to those of other developed countries. The Community Ministers have also shared this view, on the condition, of course, that the commitments subscribed to would be respected and that the decisions taken would be completely and correctly implemented by all countries.

## III. PROTRACTED AND SOMETIMES DIFFICULT NEGOTIATIONS

The multilateral trade negotiations (MTN) were formally opened upon the adoption of the "Tokyo declaration" by the Ministers of 103 countries, gathered together in September 1973 in the Japanese capital within the context of the General Agreement on Tariffs and Trade (GATT). The Tokyo meeting was the result of an initiative on the part of the United States, the European Community and Japan who, early in 1972, had agreed upon two joint declarations dealing with the timeliness of seeking ways to reduce obstacles to international trade. These declarations gave the basic political impetus to the project. Following the Tokyo meeting, negotiation structures were rapidly put into place, in Geneva. However, the leading partners still had to define their goals and acquire the necessary instruments of negotiation.

For the Community, this was done in June 1973, when the Council adopted a "global concept" specifying the goals to be attained and the conditions for reciprocity. The government of the United States had to wait until January 1975 that Congress in its "Trade Act" grant it the necessary powers to negotiate. The following month, the Community established the details of its negotiation stand.

After a long period of preparation, the actual discussions began towards the middle of 1977, when a certain number of basic divergences (concerning in particular the scope and conditions of negotiations relative to agriculture) between the Community and the United States were smoothed out. The criteria for the lowering of customs duties, with, as requested by the European Community, the acceptance of the principle according to which the highest duties were to be reduced to a greater degree so as to harmonize the tariff "profiles", were defined on the basis of a formula proposed by the Swiss. The basic agreements reached in the middle of 1977 made it possible to establish a precise schedule for the presentation of the demand and offers of the various participants with regard to "tariffs", "agriculture" and "non tariff measures" (for recurring problems), and also to achieve substantial progress in the elaboration of codes concerning the non-tariff measures liable to find multilateral solutions.

Towards the middle of 1978, an agreement in principle was achieved between the leading participants, on the content of the "final negotiation package", following a few difficult phases and several interventions at a political level. Technical difficulties were surmounted and the political will to succeed on the part of the Nine as well as of the United States, Japan and the other developed countries was confirmed. A "joint agreement memorandum" was published in July 1978, summing up the situation and mentioning the goals still to be achieved. By the end of 1978, the tariff negotiations, both in the field of industry and agriculture, as well as the elaboration of the codes had been fully completed. Several months were then necessary to iron out the last divergences and to determine the particular conditions of reciprocal concessions. In April 1979, the negotiators were able to initial the minutes recording the results of the negotiations, in view of submitting them to the respective governments and authorities. The Congress of the United States accepted these results in July 1979. Confronted with a Commission report on the October negotiations, the Council of the European Community deliberated on it at its session on October 29. In the meantime, contacts and conversations were being pursued with the developing countries and with a few developed countries, among which Australia, with a view to completing the negotiations on specific points.

A tariff protocol finalizing details of the tariff negotiations between industrialized countries was signed in July and an additional tariff protocol was established in November to enable other countries, principally the developing countries, to include their concessions.

It was not possible to conclude negotiations on one point alone, the new procedures and guidelines concerning the safeguard clause to be included in the GATT. Discussions on this subject will continue outside the Tokyo Round, and in the meantime the GATT's existing "clause" remains valid.

## IV. LOWERED CUSTOMS TARIFFS

Customs duties throughout the world had already been reduced in the past in preceding negotiations. There remained nevertheless, certain particularly high customs duties, specially within certain "irregular" tariffs which were composed of very high duties next to others which were very low. The Tokyo Round provides for a new *generalized lowering of tariff rates by close to one third* by the leading trade partners (European Community, United States and Japan in particular) and the total suppression of duties in a significant sector, *aeronautics*. Reductions will not be "linear", that is to say that they will not be identical in their percentage: the duties which at present are the highest and which are to be reduced according to the so-called Swiss formula, will be subject to greater reductions than others. This will decrease the difference between the customs tariffs of the leading partners in international trade.

The customs duty rates of the European Community will, for the greatest part be of 5 percent to 10 percent; as few as 180 duties out of several thousand included in the Community's customs tariff will exceed 10 percent and only one (the rate applied to lorry imports) will exceed 20 percent. This homogeneous tariff will continue to constitute an important element of cohesion for the Community and will enable it to maintain reasonable protection with regard to outside pressures. For sectors with special economic and social conditions, the present reduction of duties will be small or nonexistent: automobiles, lorries, shoes, fertilizers, and certain plastic and chemical products. In "sensitive" sectors such as the textile sector, protection is not provided by customs duties alone, but by quantitative agreements ("multifibre" international agreement).

*The United States* will reduce its tariff by close to a third. Thus, most of its imports will be subject to customs duties inferior to 5 percent; a few duties superior to 20 percent and even 30 percent will nevertheless still remain. In its final list, the United States thus tends to eliminate restrictions and to suppress the "American Selling Price".

*Japan* will reduce its tariff by almost one half if one takes into consideration the legal tariff (which, in fact, was not applied for several years), and by one quarter if the duties actually applied are taken into account. The profile of the Japanese tariff will be quite similar to that of the European Community (most duties will be inferior to 5 percent) but more 15 percent to 20 percent "peaks" will remain. The incidence of the Tokyo Round tariff reduction on the other industrialized countries will be less important particularly in view of the fact that the European Community already applies reciprocal exemptions in its exchanges with most of the Western European nations such as Switzerland, Austria, Sweden, Norway, Finland and Iceland.

Among the results, the following should also be mentioned: the total suppression among the leading industrial countries as a whole, of customs duties in the civil aeronautics sector, beginning in 1980. The Community had, in practice, already suspended the application of duties on its aircraft import: it finally has obtained total reciprocity, particularly significant for the Airbus sales to the United States and Japan, in addition to an extended application to exchanges of other products of this sector as well as to spare parts.

In general, the *customs reductions will be spread out over a period of eight years*, from 1980 to 1987, accelerated in certain cases such as in the field of aeronautics, as already mentioned. After the first five stages of reduction, the European Community will examine the situation to decide on proceeding to the final three stages, if disarming is pursued. The reductions as a whole should be in force by the beginning of 1987 at the latest.

## V. FREER AND MORE STABLE AGRICULTURAL EXCHANGES

The specific character of the agricultural sector, which the European Community has asserted from the start, and which has finally come to be recognized by all, has led to special solutions taking into account the fact that duties do not constitute in themselves the essential element regulating exchanges. For a few basic products — cereals, dairy products, beef — the goal was to set up special international arrangements and in two out of the three cases (with the exception of cereals) this goal was achieved. The principles and mechanisms of the Common Agricultural Policy (CAP) of the European Community were not called into question even in the aspects which had been challenged in the past (namely export refunds).

Only one important setback was noted: the failure to obtain in due time an international arrangement for cereals. The negotiations on this subject will continue outside the Tokyo Round. The arrangement on dairy products includes information and cooperation procedures for the sector as a whole, and price guidelines for powdered milk, butter, butteroil and cheese products. The beef arrangement is based on a mutual information mechanism and on a system of multilateral consultations in case of problems in the world market. In addition, it set up an "advisory organism on agricultural problems".

These arrangements and procedures are completed by specific nation-to-nation concessions. The European Community has in particular, obtained freer access to the American market for cheese products, alcohols, spirits and beef in exchange for certain concessions on poultry and on a special variety of table grapes and for a few arrangements concerning the importing of tobacco, rice and prime quality beef.

Among other positive results for Europe, the improved access obtained for cheese products (Canada, Australia, Japan), for alcoholic drinks (Canada, New Zealand, Japan) and for products of the agro-alimentary industry should be mentioned. In exchange, the European Community will stabilize the regulation of its own imports of beef and of certain dairy products coming from various countries.

## VI. IMPROVED DISCIPLINE AND MORE BALANCED DEVELOPMENT OF INTERNATIONAL EXCHANGES

The reduction, and even suppression, of customs duties would not be very significant were the possibility of introducing other obstacles to trade, of applying discriminatory measures on foreign products originating in certain areas, of applying, whenever one chooses, compensation duties, of excluding certain sectors from international competition, not contained and disciplined. It is for this reason that the defining of new, more clear-cut and more equitable rules for international exchanges constitutes one of the most important results of the Tokyo Round, without which the customs reductions would have led to advantages that were simply illusory or at the least uncertain and short-lived.

At the same time, however, it would have been unthinkable — for the European Community as for the other nations — to grant partners excessive "inspection rights" over domestic legislation and conduct, which are dictated at times by legitimate and urgent demands (for example, when public health is involved). A balance has, in general, been achieved after long and complicated negotiations. The "codes" elaborated as a result, improve and update the rules and procedures governing world trade, by facilitating the suppression or reduction of a number of non-tariff barriers to exchanges and by improving supervision.

The new rules cover the following fields:

(i) *Code on the technical obstacles to trade*, concerning obstacles resulting from the fact that the compulsory technical standards for a large number of industrial products (cars, electrical machinery, household appliances, etc.) are not the same from one country to another. The new agreement introduces procedures which, while respecting the right to establish the standards which protect the health and safety of consumers and utilizers, aim at avoiding discriminations and "disguised protectionism" (the possibility to protect national production by imposing standards which create problems that are often insurmountable for foreign producers).

(ii) *Code on Government purchases.* This code aims to eliminate legislation or administrative practices which channel government purchases to national suppliers or which provide price preferences for these purchases. The goal has only been partially achieved; but the code nevertheless opens exceptionally important markets to European industries while naturally guaranteeing a certain reciprocity. This presents two advantages: for the firms, which will benefit from a widening of their markets, and the governments which will benefit from broadened competition.

(iii) *Code on subsidies and compensation rights.* The goal of this code is to put an end to the arbitrary introduction of compensation rights on importing by guaranteeing a uniform application of the GATT provisions. The imbalance between rights and obligations which previously existed has been eleminated. On the other hand, new procedures for the discussion of domestic subsidies which could adversely affect international trade, have been established.

(iv) *Anti-dumping code* which aims at prohibiting practices which consist of penetrating foreign markets by selling at prices below the normal price. In this case, the goal has also been to eliminate the discrepancies between the various countries in their application of GATT rules. Procedures have been more clearly defined.

(v) *Code on import licences and code on customs valuations* (namely, the manner in which the value on imported products is calculated in view of applying an ad valorem customs duty to these). These codes cover technical fields, which, however, are of considerable importance to importers and exporters and to the legal basis for stability of exchanges. The same can be said of the agreement which aims at discouraging the exchange of spurious merchanidse.

An agreement on a new *safeguard clause* was not reached. At the present time, should a country note that imports of a given product provoke serious perturbations on its market, it can adopt measures of protection, which, however, according to a certain interpretation of existing rules, must be applied to all exporting countries. The new clause under consideration would establish criteria for the application of "selective" measures exclusively to products from certain sources having caused the serious prejudice observed. Certain of the developing countries opposed the clause, fearing that, in practice, the "selective clause" would be more often directed against their products. Nevertheless, the problem remains extremely urgent for a large number of GATT countries and the European Community will continue to explore the possibilities of an agreement after the Tokyo Round.

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Compilation of three studies on basic questions regarding tax law and the protection of its principles by tax courts in two representative States of the western hemisphere, i.e. Germany and the United States.
(B. 102.353)

### KAISER KARL VI

Mauth-Steuer-Ordnung aus dem Jahre 1726. By Alfons Pausch. Cologne, Peter Deubner Verlag, 1979. 32 pp.
Reprint of Mauth Tax Ordinance of 1726.
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### DER NEUE BAUHERRENERLASS

2. Auflage. Cologne, Peter Deubner Verlag, 1979. Steuer-Telex Sonderinformation. 20 pp.
Special edition of the German tax periodical "Steuertelex", dealing with the new administrative regulations on the tax treatment of "Bauherren", i.e. persons who incur the cost and risk of construction of a building.
(B. 102.390)

### EIN ÖKONOMETRISCHES MODELL ZUR PRODUKTIONS- UND PREISERKLÄRUNG IN DER DEUTSCHEN INDUSTRIE

By Joachim Fronia. Tübingen, J.C.B. Mohr (Paul Siebeck), 1979. Institut für Angewandte Wirtschaftsforschung, Schriftenreihe Band 33. 332 pp., 75 DM.
Study containing a short-term economic model on the interrelationship between production and prices in the various sectors of industry in Germany and possibilities to come to a conjunctural analysis.
(B. 102.359)

### STEUERBEGÜNSTIGTE KAPITALANLAGEN 1979/80

Herausgegeben von der Fachredaktion des Spezialdienstes Steuer-Telex. Cologne, Peter Deubner Verlag, 1979. 68 pp.
Documentation on legislation, case law and publications concerning tax favored capital investments in Germany.
(B. 102.389)

### STEUERBERATERKONGRESS-REPORT 1979

Deutscher Steuerberaterkongress 1979 der Bundessteuerberaterkammer. Ansprachen, Referate, Diskussionen. Munich, Verlag C.H. Beck, 1979. 420 pp., 72.80 DM.
Annual Tax Advisors' Congress Report of 1979, containing the texts of the proceedings, lectures and debates on such topics as current problems of financial policy, selected problems in corporate income tax, fiscal problems related to usufruct, special problems related to the new turnover tax law 1979, etc.
(B. 102.315)

### DIE ÜBERNAHME FREMDER URTEILE BEI PRÜFUNGEN

By Harald Neitemeier. Düsseldorf, IdW Verlag, 1979. Schriftenreihe des Instituts für Revisionswesen der Westfälischen Wilhelms-Universität Münster, Band 13. 212 pp., 38 DM.
Study on the theoretical and practical importance of the utilization by German tax auditors of decisions made by foreign auditors.
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Düsseldorf, IdW Verlag, 1979. 413 pp., 39.50 DM.
Text of the new German 1980 Turnover Tax Law together with the Government's substantiation, as well as the texts of the 1980 Regulatory Ordinance to the new Turnover Tax Law and the texts of EEC Directives.
(B. 102.408)

## INDIA

### COMMENTARIES ON THE CUSTOMS ACT, 1962

(Act No. 52 of 1962) (as amended up-to-date) along with various rules, interconnected provisions and useful appendices and notifications. Revised by R.B. Sethi, V. Gauri Shanker. 2nd Edition. By T.P. Mukerjee, T.P. Allahabad, Law Publishers, 1979. 1045 pp.
Comprehensive commentary on the customs law. Texts of statutes and by-laws are appended. Reference to case law illustrates the explanation per provision of the law.
(B. 51.456)

### COMMENTARIES ON THE LAW OF INCOME TAX IN INDIA

Golden jubilee - eleventh edition. By V.S. Sundaram. Revising associates: B. Malik, S.C. Manchanda and K.R. Ramamani.
In 4 Volumes. Vol. I Sections 1-34, 1978-79. Allahabad, Law Publishers, 1979. 1140 pp.
Volume I of a 4-volume commentary on the income tax law in India consists of an explanation of sections 1 to 34 of the income tax law of 1961 as revised up to October 1978.
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### LAW AND PRACTICE OF WEALTH TAX

The Wealth Tax Act, 1957 (as amended up to 15 September 1977). By Ved Prakash Verma. Calcutta, Eastern Law House, 1978. 1558 pp.
Comprehensive commentary on the wealth tax in India arranged by section per provision of the law is contained in Part I. Part II contains exemptions at a glance from 1957 to 1977. In addition, it includes valuation of assets. Texts of notes on finance bills and amended bills and relevant circulars are appended to Part II.
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### R.B. SETHI'S COMMENTARIES ON CENTRAL EXCISE ACT AND RULES

With allied laws. 2nd Edition. Revised by B. Malik, C.L. Gupta and Jagdish Lal. Allahabad, Delhi Law House, 1978. 961 pp.
Comprehensive commentary on the central excise law. Text of statutes including related laws are included. Reference to case law illustrates the explanation per provision of the law.
(B. 51.457)

## INDONESIA

### WIRTSCHAFTSPARTNER INDONESIEN

Daten - Kommentare - Wirtschaftspraxis. Editors: Rudolf O.G. Roeder and Jörg Willecke. Hamburg, Institut für Asienkunde, 1979. 232 pp.
"Business Partner Indonesia" is a compilation of studies by various authors on important features prevailing in Indonesia in connection with business or investment in Indonesia (including business law, company law and taxation).
(B. 51.460)

## INTERNATIONAL

### INTERNATIONAL ACCOUNTING, AUDITING AND TAX ISSUES

Changing rules and corporate responses. New York, Business International Corporation, 1979. 311 pp.
Study designed to set out the requirements for drafting a consolidated balance sheet as adopted in various individual countries and the changing international rules with respect to accounting, auditing as well as tax issues encountered by multinational companies in international business operations with emphasis on U.S. companies and statutes. Texts of relevant documents are appended such as the EEC Commission's Fourth Council Directive on the Annual Accounts of Corporations and Limited Liability Companies, Report of the AICPA Special Advisory Committee on Internal Accounting Control - The Minahan Report, EEC Proposal for a Seventh Council Directive concerning group accounts.
(B. 102.344)

### LABOR RELATIONS LAW: CANADA, MEXICO AND WESTERN EUROPE

By Gary E. Murg and John C. Fox. New York, Practising Law Institute, 810 Seventh Avenue, New York, N.Y. 10019., 1978. 1433 pp.
Labour systems explained in two volumes on the following countries: Canada, Mexico, the United Kingdom, Belgium, France, Italy, the Netherlands and the German Federal Republic.
(B. 102.362)

### MANUAL FOR THE NEGOTIATION OF BILATERAL TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES

New York, United Nations, 1979. 190 pp., $10.
Three-part manual consolidating the findings on the guidelines for the conclusion of tax treaties between developed and developing countries as developed by the Group of Experts set up by the United Nations. Part One contains an analytical and historical review of international double taxation and tax evasion and avoidance. Part Two contains, in consolidated form, the guidelines formulated by the Group of Experts. Part Three contains suggestions relating to procedural aspects of tax treaty negotiations and to the application of the guidelines. Appended to the manual are texts of model tax treaties, both bilateral and multilateral.
(B. 102.318)

### 1978 STATISTICAL YEARBOOK/ANNUAIRE STATISTIQUE 1978

Thirtieth issue. New York, United Nations, 1979. 966 pp.
This edition of the Statistical Yearbook 1978 contains annual data received up to the end of 1978 and in most cases covers the last ten years.
(B. 102.322)

## IRELAND

### TOLLEY'S TAXATION IN THE REPUBLIC OF IRELAND 1979-80

By Nigel A.D. Lambert and Eric L. Harvey. Croydon, Tolley Publishing, Ltd., 1979. 160 pp., £5.50.
A detailed guide to taxation in the Republic of Ireland covering income tax, capital gains tax, capital acquisition tax, wealth tax, corporation tax and value added tax, and including the provisions of the Finance Act 1979.
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## ISLE OF MAN

### ANATOMY OF A TAX HAVEN

The Isle of Man. By Mark Solly. Douglas, Shearwater Press, Ltd., 1975. 132 pp.
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### BILANCIO DI ESERCIZIO E DICHIARAZIONE DEI REDDITI

By Enrico Nuzzo. Naples, Casa Editrice Dott. Eugenio Jovene, 1979. 155 pp.
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## MALTA

### INTO THE EIGHTIES: OPTIONS FOR THE ECONOMY

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## MEXICO

### COMPILACION DE IMPUESTOS ESPECIALES

Mexico, Secretaría de Hacienda y Crédito Público, 1979. 180 pp.
Texts of laws and implementary decrees on excise duties (liquor, fermented products and beer).
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## MONACO

### FISCALITE EUROPEENNE: MONACO

2 Volumes. By Pierre Fontaneau. Nice, Les Cahiers Fiscaux Européens, 1979.
Loose-leaf publication in two volumes on the tax system in Monaco, one of a series of loose-leaf volumes describing the taxes in EEC member countries and other European countries in a uniform way for purposes of comparison.
(B. 102.316)

## THE NETHERLANDS

### HET ABC VAN HET BELASTINGRECHT

By W.J. de Langen. 8e druk, bewerkt door D. Brüll, A. Hartman, R. Oorthuizen en J. van Soest. Alphen a.d. Rijn, Samsom, 1979. 114 pp.
Introductory textbook dealing with the corporate income tax, individual income tax, net wealth tax and related by-laws in the Netherlands.
(B. 102.368)

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25ste editie. By J. Viersen and E.N. Jonker. Amsterdam, Annoventura, 1980. 320 pp., 15.50 Dfl.
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English translation of the statutory texts of company law in the Netherlands and in the Netherlands Antilles.
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By Wouter J. Keller. Rotterdam, Erasmus University, 1979. IFA, Discussion Paper Series, No. 7901/P. 25 pp.
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### FUSIE

By C.A. Boukema. Zwolle, Tjeenk Willink, 1979. Studiepockets Bedrijfsrecht, No. 2. 139 pp., 22 Dfl.
Monograph on merger under the Netherlands legal and tax law system.
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Monograph on the problem in Netherlands income tax law which arises where an entrepreneur liquidates his business in exchange for annuities.
(B. 102.321)

### DE TELEGRAAF BELASTINGGIDS 1980

By J.L. van Hedel. Amsterdam, Teleboek, 1979. 303 pp., 14.50 Dfl.
Annual guide for filing 1979 individual income tax return and 1980 net wealth tax return, including a summary on inheritance tax and gift tax, municipal real property tax and school contributions.
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### HET VERREKENINGSSTELSEL IN OPMARS: WAT DOET NEDERLAND?

Editor: S. Cnossen. Deventer, Kluwer, 1979. Geschriften van het Fiscaal Economisch Instituut van de Erasmus Universiteit Rotterdam, No. 6. 116 pp., 34.50 Dfl.
Compilation of contributions and commentary at a congress convened by the University of Rotterdam on the subject of the imputation system with reference to the developments and existing systems in the EEC member countries and the situation in the Netherlands.
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### VALUE-ADDED TAX IN THE NETHERLANDS

The Hague, Ministry of Finance, 1979. 27 pp.
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## NEW ZEALAND

### OVERSEAS INVESTMENT IN NEW ZEALAND

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Brochure providing information for foreign investors on business conditions and laws affecting investments in New Zealand, including taxation, company law, foreign exchange regulations.
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## NIGERIA

### COMPANY TAX LAW IN NIGERIA

By J. Ola Orojo. London, Sweet & Maxwell, 1979. 300 pp., £ 14.
Monograph explaining the corporate income tax contained in the Company Income Tax Act 1961, the petroleum profits tax and the capital gains tax in Nigeria. The consolidated text of the Company Income Tax Act 1961 as amended up to July 1978 is included. (B. 13.048)

### RECURRENT AND CAPITAL ESTIMATES OF THE GOVERNMENT OF THE FEDERAL REPUBLIC OF NIGERIA 1979-80

Lagos, Federal Ministry of Information, 1979. 618 pp.
Text of Budget Speech for 1979/80, press statement on the 1979/80 Budget, consolidated financial statement 1979/80 and summaries of revenue and expenditure estimates for 1979/80.
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### OECD ECONOMIC OUTLOOK

No. 26. Paris, Organisation for Economic Co-operation and Development, 1979. 145 pp.
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### PRIX DE TRANSFERT ET ENTREPRISES MULTINATIONALES

Rapport du Comité des Affaires Fiscales de l'OCDE 1979. Paris, Organisation for Economic Co-operation and Development, 1979. 106 pp., 36 Ffr.
French version of a report also available in English, entitled "Transfer pricing and multinational enterprises".
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## PANAMA

### EL DERECHO LABORAL EN CENTROAMERICA Y PANAMA

3 Volumes. By Fernando E. García Rodríguez. Tegucigalpa, Banco Centroamericano de Integración Económica (BCIE), 1977. 70 + 333 + 228 pp.
Three-volume handbook on labour legislation in Panama and Central America.
(B. 15.935)

## PAPUA NEW GUINEA

### FOREIGN INVESTMENT POLICY

Port Moresby, Institute of National Affairs, 1977. Institute of National Affairs, Discussion Paper No. 1, August 1977. 155 pp.
This document contains the findings of the first research project undertaken by the Institute of National Affairs. The purpose of the project is to improve the dialogue between the Government and the private sector, particularly in policy areas of mutual interest. Contributions include the following: "Papua New Guinea's foreign investment policy" by John Wylie; "A general outline of the government's economic policies with specific reference to overseas investors" by the Hon. J. Chan; "Present government thinking on investment policy for extractive industries" by N. Agonia.
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## PARAGUAY

### LEGISLACION FISCAL DEL PARAGUAY

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## PHILIPPINES

### PHILIPPINE TAX SYSTEM UNDER THE NEW SOCIETY

By Angel Q. Yoingco and Vicente G. Quintos. Manila, Angel Q. Yoingco and Vicente G. Quintos, 1979. 617 pp.
Study of the tax reforms during the period 1972-1978. It discusses the 338 presidential decrees, letters of instruction and memorandum circulars issued during the period up to June 11, 1978. Complete listing of tax legislation is appended.
(B. 51.368)

### A SHORT GUIDE TO PHILIPPINE TAXES

Revised edition. Manila, National Economic and Development Authority, National Tax Research Center, 1979. 69 pp.
Introductory guide describing the tax system of the Philippines as of December 1978.
(B. 51.453)

## SINGAPORE

### INVESTOR'S GUIDE TO THE ECONOMIC CLIMATE OF SINGAPORE

Seventh edition. Singapore, Singapore International Chamber of Commerce, 1979. 100 pp.
Guide describing the investment climate and the facilities, requirements and opportunities for investors in Singapore.
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## SOUTH AFRICA

### 1979/80 SUPPLEMENT TO SILKE ON SOUTH AFRICAN INCOME TAX

By Costa Divaris and Michael L. Stein. Ninth edition. Consulting editor: Aubrey S. Silke. Cape Town, Juta & Company, Ltd., 1979. 528 pp.
Supplement to be used in conjunction with the ninth edition of Silke on South African Income Tax bringing the material up to date as of the 1980 tax assessment year.
(B. 13.047)

## SPAIN

### CURSO DE SISTEMA FISCAL ESPANOL

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Handbook on the Spanish tax system as it was before the 1979 tax reform.
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### ESTUDIOS DE DERECHO TRIBUTARIO

2 Volumes. Madrid, Ministerio de Hacienda, 1979. 1755 pp.
Two-volume handbook containing 37 articles by various authors on general principles of tax law.
(B. 102.442)

### EEN HUIS KOPEN IN SPANJE

By C.E. van der Lande. Alphen a.d. Rijn, Samsom, 1979. 120 pp.
Introductory guide for those who intend to buy real estate in Spain. Legal, administrative and taxation aspects are dealt with.
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## SWEDEN

### THE SWEDISH BUDGET 1980/81

A summary published by the Ministry of Economic Affairs and the Ministry of the Budget, Stockholm, 1980. 167 pp.
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## SWITZERLAND

### DOPPELBESTEUERUNGSABKOMMEN ZWISCHEN DER SCHWEIZ UND ENTWICKLUNGSLÄNDERN

Eine entscheidungs- und problemorientierte Darstellung. By Lucius Jenal. Basel, Lucius Jenal, 1979. 320 pp.
Doctoral thesis on income treaties for the avoidance of double taxation concluded by Switzerland with developing countries.
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## UNITED KINGDOM

### BYLES ON BILLS OF EXCHANGE

The Law of Bills of Exchange, Promissory Notes, Bank Notes and Cheques. 24th Edition. By Maurice Megrah and Frank R. Ryder. London, Sweet & Maxwell, 1979. 509 pp., £35.
Monograph on the Law of Bills, Cheques and Promissory Notes.
(B. 102.324)

### CORPORATION TAX

Fourth edition. By B.S. Topple. Plymouth, Macdonald and Evans, 1979. 186 pp., £2.75.
Fourth edition of textbook explaining the corporation tax based on the law updated to take account of the Finance (No. 2) Act 1979.
(B. 102.416)

### DOUBLE TAXATION RELIEF

A detailed explanation of the law and practice of double taxation relief. By Deloitte Haskins & Sells. Croydon, Tolley Publishing Company, Ltd., 1979. 175 pp., £7.95.
Study on the double taxation relief in United Kingdom law and practice on income and capital gains as well as gift and inheritance taxes. The law and agreements are stated as of August 1, 1979.
(B. 102.384)

### KEY TO CAPITAL GAINS TAX

Capital Gains Tax Act, 1979 Edition. By K.R. Tingley. London, Taxation Publishing Company, Ltd., 1979. Taxation Master Key Series. 391 pp., £6.25.
Annual guide presenting explanation of the capital gains tax law and practice as stated as of September 1, 1979.
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### KEY TO CORPORATION TAX

Finance (No. 2) Act, 1979 Edition. By T.L.A. Graham. London, Taxation Publishing Company, Ltd., 1979. Taxation Master Key Series. 343 pp., £6.25.
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### PINSON ON REVENUE LAW

First supplement to the twelfth edition. Up to date to August 1, 1979. By Barry Pinson. London, Sweet & Maxwell, 1979. 30 pp., £1.
Supplementary text to the basic work.
(B. 102.328)

### SUPPLY ESTIMATES 1979-80 FOR THE YEAR ENDING 31ST MARCH 1980

Supplementary estimates (classes II-XVII: CIVIL). London, Her Majesty's Stationery Office, 1979. 387 pp.
Presentation of the Supplementary Estimates 1979-80 necessary to secure additional money and Parliamentary authority in connection with the cost of services.
(B. 102.371)

### TAKE-OVERS AND MERGERS

Fourth edition. By M.A. Weinberg, A.L. Greystoke and M.V. Blank. London, Sweet & Maxwell, 1979. 854 pp., £45.
Fourth edition of revised systematic reference work on the law and the practice relating to take-overs and mergers with reference to law and regulations in force as of April 1, 1979.
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### TOLLEY'S CAPITAL GAINS TAX 1979-80

A comprehensive detailed guide to capital gains tax including the legislation and relevant case law to 30 September 1979.
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### TOLLEY'S INCOME TAX 1979-80

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## U.S.A.

### BITTKER AND EUSTICE'S FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS

Fourth edition. 1979 Supplement. By James S. Eustice. Boston, Warren, Gorham & Lamont, 1979. 186 pp.
Supplement to basic work with extensive tables of contents.
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### CORPORATION — PARTNERSHIP — FIDUCIARY FILLED-IN TAX RETURN FORMS

1979 Edition. Chicago, Commerce Clearing House, Inc., 1979. 128 pp., $3.50.
Guide for filing in 1979 the 1978 income tax returns of corporations, partnerships, estates and trusts.
(B. 102.340)

### EMPLOYEE STOCK OWNERSHIP PLANS

Edited by Joseph E. Bachelder III. New York, Practising Law Institute, 810 Seventh Avenue, New York, N.Y. 10019. 1979. 788 pp., $40.
Articles by various authors on the development and provisions of the Employee Retirement Income Security Act of 1974 and amendments.
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### FEDERAL TAX HANDBOOK 1980

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Annual guide for filing company and personal income tax returns for the 1979 tax year.
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### 1980 GUIDEBOOK TO LABOR RELATIONS

Chicago, Commerce Clearing House, Inc., 1979. 392 pp., $8.50.
Annual guidebook presenting explanation and summary of the general principles of labor relations law and the important rules developed under the statutes and decisions.
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### A GUIDE TO CORPORATE TAX PLANNING

Third edition. By Sidney Kess. Chicago, Commerce Clearing House, Inc., 1979.
Two cassette tapes dealing with planning as part of audit work and planning at year-end. Two booklets are appended entitled: "Quizzer" and "Checklists".
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### INCOME TAX TREATIES

Edited by Jon E. Bischel. New York, Practising Law Institute, 810 Seventh Avenue, New York, N.Y. 10019. 1978. 959 pp.
Compilation of studies in the field of international taxation, particularly United States bilateral tax treaties with other countries (the United Kingdom, France, The German Federal Republic and Japan), as well as a description of the structure and operation of tax treaties in general. Contributions include: "The historical development of income tax treaties" by Mitchell B. Carroll; "Permanent establishments in the United States" by Robert L. Williams; "The effect of tax treaties on transfer of technology" by Jon E. Bischel; "The United States-German tax convention" by Henry J. Gumpel; "Working with the Japanese treaty" by John Huston. An extensive bibliography and the text of the 1977 OECD Model Tax Treaty are appended.
(B. 102.361)

### INDIVIDUALS' FILLED-IN TAX RETURN FORMS

1980 Edition. Including: sample filled-in forms, rate tables, work sheets, check lists. Chicago, Commerce Clearing House, Inc., 1979. 136 pp., $3.
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### INTERNAL REVENUE CUMULATIVE BULLETIN 1978-1 JANUARY-JUNE

Washington, Government Printer, 1979. 615 pp.
Consolidation of all official rulings, decisions, executive orders, tax treaties and other items of a permanent nature, published in the weekly Bulletins in the first half of 1978.
(B. 102.319)

### SUPPLEMENT TO 1979 US MASTER TAX GUIDE

For 1978 income tax returns and 1979 tax planning. Chicago, Commerce Clearing House, Inc., 1979. 560 pp.
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Introduction identifying possible investment opportunities for profit and methods for reducing or deferring income taxes.
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## URUGUAY

### COMPILACION DE NORMAS APLICABLES A LOS TRIBUTOS RECAUDADOS POR LA DIRECCION GENERAL IMPOSITIVA

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# Tax Developments in Singapore

BY LEE FOOK HONG, FCIS, FAIA

# I. TAX CHANGES

**Contents**



## A. THE ECONOMIC EXPANSION INCENTIVES (RELIEF FROM INCOME TAX) (AMENDMENT NO. 2) ACT, 1979

The Economic Expansion Incentives (Relief from Income Tax) (Amendment No. 2) Act, 1979 was passed by Parliament on December 11, 1979 and assented to by the President on December 18, 1979. It was published in the Singapore Government Gazette Act Supplement No. 31 dated December 28, 1979.

This Act amends the Economic Expansion Incentives (Relief from Income Tax) Act to ensure that in computing the export profit of an export enterprise which qualifies for tax relief under Section 32 of the Act, such part of the capital allowance as may be attributable to the export profit qualifying for the tax relief must be deducted.

The Amendment will take effect from the Year of Assessment (Y/A) 1980.

## B. INCOME TAX (AMENDMENT) ACT, 1980

The Income Tax (Amendment) Act, 1980 was passed by Parliament on March 17, 1980 and assented to by the President on March 26, 1980.

It was published in the Government Gazette Act Supplement No. 12 dated April 3, 1980. [1]

The Income Tax (Amendment) Act, 1980 seeks to implement some of the tax changes announced in the Government's 1979 Budget proposals and also to make other amendments to the Income Tax Act.

The major tax changes effected by the Amendment Act are summarised in the Appendix hereto. Below are some brief notes on the amendments to the various sections and the respective dates on which such amendments will be effective.

1. The Act Supplement is obtainable from the Singapore National Printers (Pte.) Ltd., 303 Upper Serangoon Road, Singapore 1334 and S.N.P. Publications Sales Division, Fullerton Building, Ground Floor, Singapore 0104. The price is S$ 1.50 per copy.

Section 10(1A) Effective from Y/A 1980

## 1. Net annual value of owner-occupied properties

The proviso to Section 10(1A) has been amended to include ".......... any property owned by a married woman living with her husband shall be deemed to be owned by the husband."

Before the amendment, the Act allows a husband and a wife to claim exemption from income tax on one property each.

After the amendment, only one property for each couple will be exempt from income tax with effect from the Year of Assessment 1980.

Section 10(8) Effective from Y/A 1979

## 2. Maintenance payment received by a child

This new Section 10(8) provides that any maintenance payment made to a child under a court order or a deed of separation is not deemed to be income and therefore will not be subject to tax.

Section 10(6A)
Section 13(1)(x) Effective Y/A 1979

## 3. Exemption for pensions

Since the Year of Assessment 1977 only 50 percent of the pension derived by a Singapore resident has been subject to tax. This Section has now been deleted and the following new paragraph (x) has been added to Section 13(1):

> "(x) the income derived by a person resident in Singapore from any pension granted under any written law relating to pensions in Singapore or under such other pensions scheme as may be approved by the Minister by notification in the Gazette."

Accordingly any pension granted under any written law in Singapore as well as under any approved private pension scheme designated by the Minister will be exempt from tax with effect from the Year of Assessment 1979.

Section 14(3A) Effective 1.4.79

## 4. Deduction from car expenses

A new Sub-section (3A) has been added to Section 14 to increase the limitation on the amount of allowable expenses from \$15,000 to \$25,000 in respect of a motor car acquired on or after April 1, 1979. The effect of this amendment is that the deduction for expenses incurred by any business service passenger vehicle with "Q" registration costing more than \$25,000 purchased on or after April 1, 1979 shall be limited to the amount which bears to such outgoings and expenses the same proportion as \$25,000 (previously \$15,000) bears to the capital expenditure incurred by the owner in respect of the motor car. For example:

1) Total running expenses incurred is \$5,000
2) QEL 1234 costing \$30,000 was purchased in November 1979
3) The amount to be allowed against taxpayer's income will be $\frac{25,000}{30,000} \times \$5,000 = \$4,166.70$

Section 14B (3)(c) Effective 1.4.79

## 5. Double deduction not allowed

This amendment precludes any company which is enjoying tax relief under the Economic Expansion Incentives (Relief from Income Tax) Act from being given double deduction of expenses under that Section.

Section 14C Effective 1.4.79

## 6. Double deduction for export market development expenditure

The new Section 14C provides for double deduction of the following expenses incurred on or after April 1, 1979 by a company resident in Singapore principally for promoting the export of goods manufactured in Singapore:

a) Export market development expenditure incurred in carrying out a marketing project overseas approved by the Minister; or
b) Advertising expenses in respect of advertisements placed in any approved Singapore publication designed for publicity overseas.

Section 14D Effective 1.4.79

## 7. Expenditure on scientific research projects

A new Section 14D has been inserted to provide for deduction of expenditure on scientific research incurred on or after April 1, 1979 by a manufacturing company where the deduction would not be allowable as revenue expenses under Section 14 of the Act. The expenditure must be incurred on scientific research carried out in Singapore and related to the trade or business of the taxpayer or consist of payments to an approved research institute for scientific research related to the taxpayer's trade or business.

Expenditure of a capital nature e.g. capital expenditure incurred on plant, machinery, land or buildings will qualify for deduction.

Section 15(1)(j) — Effective Y/A 1980

**8. Motor cars registered and used outside Singapore**

Section 15(1)(j) has been amended to allow deductions for expenses incurred in respect of motor vehicles registered outside Singapore and used exclusively outside Singapore provided such vehicles are used for the purposes of producing income subject to Singapore income tax.

Section 19(2A) — Effective Y/A 1980

**9. Capital allowances on cars limited to $25,000**

A new proviso to Section 19(2A) has been introduced to increase the limitation on capital allowances from $15,000 to $25,000 in respect of a motor car acquired on or after April 1, 1979.

When a business service passenger vehicle costing more than $25,000 was purchased on or after April 1, 1979 the respective amounts of initial and annual allowances claimed shall be limited to 20 percent each of $25,000.

For example, if a business passenger car (QEL 1234) was purchased in November 1979, costing $30,000, the initial and annual allowances to be allowed for Year of Assessment 1980 will be restricted to $5,000 and $5,000 respectively.

*(Note:* There are proposals in the 1980 budget for new depreciation rates and change from reducing balance method to straight line method).

Section 19(2D) — Effective

**10. Capital allowances for cars registered and used outside Singapore**

This sub-section has been amended to enable capital allowances to be granted in respect of motor vehicles which are registered outside Singapore and used exclusively outside Singapore provided such cars are used for the purposes of producing income liable to Singapore income tax.

Section 20(5)(c) — Effective 1.4.79

**11. Sale price of cars purchased on or after 1.4.79**

Consequent upon the increase in the limitation of capital allowances from $15,000 to $25,000 the sale price of a business service passenger vehicle purchased on or after April 1, 1979 costing more than $25,000 will be computed according to the following formula:

$$\frac{25{,}000}{\text{purchase price of the car}} \times \text{selling price}$$

Section 20(5A) — Effective Y/A 1981

**12. Balancing allowances for business service passenger vehicles only**

This new Sub-section has been introduced to assure that no balancing allowances will be granted on the sale of a motor car which is not, for any basis period after the basis period for the Year of Assessment 1981, registered as a business service passenger vehicle.

**Section 39(2)(e)(ii)** **Effective Y/A 1980**

### 13. Central Provident Fund (CPF) contributions

The maximum amount of compulsory contributions made to the CPF Board allowable as relief has been increased from $4,000 to $5,000.

For example, if Mr. A's CPF contribution for the year 1979 is $5,080 the maximum amount of CPF to be allowed against his assessable income will be $5,000 (maximum) for the Year of Assessment 1980.

This amendment also applies to compulsory contributions made to other pension or provident fund schemes approved by the Minister for Finance.

**Section 26**
**Section 43C** **Effective Y/A 1980**

### 14. Concessionary rate of tax for income from insuring of offshore risks

The scope of the concessionary rate of tax for insurance companies under Section 43C of the Act has now been extended by the amendment act from income derived from the *reinsuring* of offshore risks to income derived from the *insuring* of offshore risks.

**Republic of Singapore**

**Personal income tax**
**Old and new rates compared**

| Chargeable Income | Old | | New | | Savings |
|---|---|---|---|---|---|
| | Old Rate % | Tax Payable | New Rate % | Tax Payable | |
| On the first 2,500 | 5 | 125 | 4 | 100 | 25 |
| On the next 2,500 | 8 | 200 | 7 | 175 | 25 |
| On the first 5,000 | | 325 | | 275 | 50 |
| On the next 2,500 | 10 | 250 | 9 | 225 | 25 |
| On the first 7,500 | | 575 | | 500 | 75 |
| On the next 2,500 | 12 | 300 | 11 | 275 | 25 |
| On the first 10,000 | | 875 | | 775 | 100 |
| On the next 5,000 | 15 | 750 | 14 | 700 | 50 |
| On the first 15,000 | | 1,625 | | 1475 | 150 |
| On the next 5,000 | 20 | 1,000 | 17 | 850 | 150 |
| On the first 20,000 | | 2,625 | | 2,325 | 300 |
| On the next 5,000 | 25 | 1,250 | 21 | 1,050 | 200 |
| On the first 25,000 | | 3,875 | | 3,375 | 500 |
| On the next 10,000 | 30 | 3,000 | 26 | 2,600 | 400 |
| On the first 35,000 | | 6,875 | | 5,975 | 900 |
| On the next 15,000 | 35 | 5,250 | 32 | 4,800 | 450 |
| On the first 50,000 | | 12,125 | | 10,755 | 1350 |
| On the next 25,000 | 40 | 10,000 | 34 | 8,500 | 1500 |
| On the first 75,000 | | 22,125 | | 19,275 | 2850 |
| On the next 25,000 | 40 | 10,000 | 36 | 9,000 | 1000 |
| On the first 100,000 | | 32,125 | | 28,275 | 3850 |
| On the next 100,000 | 45 | 45,000 | 40 | 40,000 | 5000 |
| On the first 200,000 | | 77,125 | | 68,275 | 8850 |
| On the next 200,000 | 50 | 100,000 | 45 | 90,000 | 10,000 |
| On the first 400,000 | | 177,125 | | 158,275 | 18,850 |
| On the next 200,000 | 55 | 110,000 | 50 | 100,000 | 10,000 |
| On the first 600,000 | | 287,125 | | 258,275 | 28,250 |
| Over 600,000 | 55 | | 55 | | |

# II. SUMMARY OF THE 1980 BUDGET*

On March 5, 1980, the Minister for Trade and Industry, Mr. Goh Chok Tong, presented his 1980 Budget to the Parliament of the Republic of Singapore. Before outlining the financial policy for the coming year, he summarised the salient points of the "Economic Survey of Singapore 1979" and spelt out the economic objectives for the future and the strategies for the Eighties.

### Singapore's economic performance in the seventies

In his summary of Singapore's economic performance in the 1970s Mr. Goh revealed that Singapore's economy grew at an average annual rate of 6.8 percent in 1974 and 4.0 percent in 1975. For the decade as a whole, real GDP grew at an average rate of 9.4 percent per annum, better than the 8.7 percent achieved in the Sixties.

### Singapore's economy in 1979

On Singapore's economy in 1979 Mr. Goh said that in 1979 world economic performance remained sluggish for the third successive year. The industrialised economies averaged a growth of 3 1/4 percent, slower than the already poor growth rates of 3.7 and 3.9 percent in 1977 and 1978 respectively. World trade grew by 7 percent, slightly faster than the previous year. Inflation, however, worsened. Consumer prices climbed up to 10 percent, from 8 percent in the previous two years.

Singapore's economic performance in 1979 was encouraging, and better than the previous years. Real GDP rose by 9.3 percent, as against 8.6 percent for 1978. The higher rate of growth was achieved with relative price stability. Despite the higher oil prices and the larger wage increase recommended by the National Wages Council (NWC), consumer prices rose by only 4 percent, lower than the 4.8 percent in 1978. Unemployment was reduced to 3.3 percent from 3.6 percent in the previous year.

All sectors of Singapore's economy expanded. Manufacturing grew by 14 percent, the highest rate of expansion since the recession. The value of external trade rose substantially by 32 percent, but this was due mainly to oil price increases.

Mr. Goh said that overall he would have rated last year's economic performance as excellent had it not been marred by one black spot — declining productivity growth. Economic expansion was achieved more through a quantitative input of workers than through productivity increases. Employment increased by 6.6 percent, 2.1 percentage points higher than the previous year, while productivity growth fell to 2.6 percent, from 4 percent in 1978.

### Economic objectives and development strategies for the Eighties

Outlining his development strategies for the 1980s, Mr. Goh set clearly defined targets for 1990. Singapore's development strategies for the 1980s aimed at attaining the standard of living achieved by Japan in 1978. This means that the target is an 8-10 percent annual growth in the 1980s.

*"If we succeed, we shall attain in 1990, a per capita income of S$15,000 to S$18,000 (at 1979 prices) which Japan has already achieved in 1978"*, said Mr. Goh. He then proceeded to elaborate on the objectives in specific areas.

On industrial development Mr. Goh said that in the 1980s, he would like the manufacturing sector to become even more dynamic, increasing its share of GDP from the present 22 percent to 31 percent by 1990, and leading the economy through consistent high productivity increases.

The Singapore Government will provide better jobs with higher wages for a better educated and trained population as well as opportunities for local entrepreneurs to participate in industries either on their own or in joint ventures with foreign investors.

On trade development the Minister forecasts that by 1990 manufactured goods will comprise 60 percent of exports if Singapore succeeds in achieving its industrial goals in the 1980s.

Through the tax incentives for international trading companies, the Government will encourage the formation of multi-activity international trading companies to push the export of Singapore manufactured products in overseas markets. The double tax deduction scheme will be extended to cover overseas marketing campaigns.

On services development Mr. Goh said that in the 1980s Singapore would be developed into a financial supermarket offering a wide and sophisticated range of financial services. The Government aims to develop Singapore into an international funds management centre. Bankers would be encouraged to improve efficiency and productivity through greater computerisation and other forms of automation.

Transport and communication were the leading growth sectors in the 1970s. These sectors will remain an important pillar of the economy while computer services will be more actively promoted in Singapore and overseas.

The export of consultancy and technical expertise will become more important in the 1980s. The conces-

* See for an excerpt of the Budget Speech 1980 page 150 of the April 1980 issue of the BULLETIN.

sionary tax on income and the 5 percent preferential margin to local contractors should help in the aim of exporting consultancy services.

Computer services are a crucial area to concentrate on and Singapore should also plan to export its computer software and services.

To stimulate utilisation, computers and peripheral equipment will be allowed to be written off in three years for tax purposes. In addition to the incentives given to International Consultancy Services, the Government is studying the feasibility of granting pioneer status for highly sophisticated computer software activities which are export-oriented as well as providing a concessionary tax rate of 10 percent, for a period of five to ten years for certain computer-related specialised companies.

On ASEAN economic cooperation the Minister stressed that in the 1980s, Singapore would continue to seek and foster closer economic cooperation within ASEAN for Singapore has a stake in the stability and prosperity of the ASEAN region.

On manpower development Mr. Goh said that the pressing need throughout the restructuring of manufacturing industry would be for an abundant supply of skilled, technical and professional manpower. Exact needs are still being worked out and the universities and technical institutions will be asked to expand rapidly. Singapore will be short of engineers in the 1980s at the current rate of output from the University. The University of Singapore will be asked to expand and re-constitute its Engineering Faculty to produce more and better-suited engineers to service and manage Singapore's expanding economy.

Professionals need experience to measure up to international standards of professional competence. It is, therefore, necessary to ensure that there are no closed shop practices of professional cartels. Registration for professionals like architects, doctors, engineers, accountants and lawyers would be further liberalised.

The Minister added, "*To help overcome shortages of labour, policies would be reviewed to attract more females to take up employment and to encourage older people who are still fit to remain in employment.*"

On the Budget for the coming fiscal year, the Minister said that it has been formulated on the basis of the following guidelines:

(a) *Financial prudence:* We shall continue with the prudent policy of keeping Government recurrent expenditure down to the minimum and within the revenue expected to be collected within the fiscal year, But consistent with a high standard of administration.

(b) *Development objectives:* The Budget should reflect the thrust and objectives of our policy to restructure the economy and of our development strategies for the Eighties. It should balance economic growth with social objectives. Investment in infrastructural development should be matched by investment in people and improvements in housing and other social amenities.

After quoting figures for the total estimated expenditure and revenue for the financial year 1980, the Minister proposed the following:

(a) Tax changes
(b) Tax concessions
(c) Personal income tax
  (i) Reduction in tax rates, and
  (ii) Relief for handicapped persons.

### Tax changes

#### Withdrawal of protection for cigarettes and tobacco

At present, the manufacture of cigarettes is protected through the imposition of an import duty higher than excise duty. Withdrawal of protection is in keeping with the development strategy to expose to competition those industries which should have grown out of the fledgling stage. The Singapore Government has, therefore, decided to remove this protection for cigarette manufacture by harmonizing excise duty with import duty. Excise duty on cigarette manufacture will therefore be raised from $4 per kilogram to $9 per kilogram. The import duty of cut rag will also be increased from $35 per kilogram to $36 per kilogram.

### Tax concessions

#### (i) Research and development

To encourage manufacturers to develop new products and processes, and to modify existing ones, specific tax incentives will be given to promote R & D activities in Singapore.

For manufacturing enterprises conducting R & D and R & D institutions servicing them, the following tax incentives will be given:

(a) Double deduction of R & D expenditure, other than on buildings and equipment, on a case-by-case basis;
(b) Accelerated depreciation over three years for all plant and machinery for R & D;
(c) Investment allowance of up to 50 percent of the capital investment in R & D, excluding building costs, on a case-by-case basis;
(d) Extension of the initial allowance of 25 percent and annual allowance of 3 percent, presently available only to industrial buildings and structures, to R & D buildings; and
(e) Capitalisation and writing-off of lump sum payments for manufacturing licensings for a period of 5 years.

These concessions will take effect from Year of Assessment 1981.

#### (ii) Capital allowances for plant and machinery

In line with Singapore's policy to develop high technology and to assist enterprises to mechanise, computerise, and upgrade their operations, the tax treatment of capital allowances for plant and machinery will be liberalised as follows:

(a) Accelerated depreciation allowance of 33 1/3 percent over three years will be extended to investment in computers and R & D equipment;
(b) The method of granting annual allowances will be converted from the reducing balance to the straight line method; and
(c) The existing depreciation schedule will be replaced by another with more realistic rates for write-offs. See Appendix I to the Budget speech on page 153.

(iii) Stamp duties

In previous years, many incentives have been given to promote the development of Singapore as a financial centre. This year, the Government intends to remove the inconveniences experienced by financial enterprises by removing certain duties altogether and rationalising others at a single rate:

(a) *Mortgages and debentures*
The existing rates of duty on mortgages and debentures will apply but the maximum amount payable is now fixed at $500.

(b) *Marketable securities*
Asian Dollar and Singapore Dollar Bonds are presently granted stamp duty remission on a case-by-case basis. The exemption will now be given across the board.

Stamp duty on contract notes for the trading of marketable securities will also be abolished.

(c) *ACU offshore loan agreements*
The present 1/2 percent ad valorem stamp duty, subject to a maximum of $500 on ACU offshore loan agreements, will be abolished.

In addition, stamp duties on all other documents relating to ACU offshore loans will be abolished.

(d) *Share certificates*
The 0.1 percent ad valorem duty on share certificates will be removed.

(e) *Share transfer deeds*
The 0.2 percent and 0.3 percent duty on share transfer deeds will be standardised at 0.2 percent.

(f) *Insurance plicies*
The existing multifarious duties will be standardised at a single rate of $1 per document.

(g) *Partnership agreements*
The existing manifold rates will be standardised at a single rate of $10.

(h) *Promissory notes*
The duty will be revised to $1 per note.

Stamp duties on the following instruments in the First Schedule of the Stamp Act will also be removed completely:

Article 3 — Agreement or Memorandum of Agreement
Article 7 — Appraisement
Article 8 — Apprenticeship Deed
Article 12 — Average Bond
Article 13 — Award
Article 25 — Contract
Article 28 — Copy or Extract
Article 33 — Deed of any kind not described in this Schedule
Article 37 — Extract
Article 43 — Letter of Allotment and Letter of Renunciation
Article 48 — Note of Protest by the Master of a Ship
Article 54 — Protest of Bill or Note
Article 55 — Protest by the Master of a Ship
Article 67 — Valuation
Article 68 — Warrant for Goods

The concessions on stamp duties will take effect from 1 April 1980.

(iv) Concession for off-shore gold transactions

The Singapore Government has received representations that the tax rate of 40 percent on income derived from off-shore gold transactions inhibits the development of the market. The matter has been studied and Government has decided to remove this disincentive. With effect from the year of assessment 1981, the 10 percent concessionary tax rate will apply to the following income derived from gold transactions with non-residents:

1) Profits arising from the transactions of Asian Currency Units (ACUs) with non-residents, other ACUs, and broker and dealer members of the Gold Exchange of Singapore (GES) in the Singapore and overseas gold markets. This is an extension of the concession so far given to ACUs on income derived from off-shore transactions with non-residents.
2) Fees, commissions and profits of approved broker and dealer members of the GES, that is, those approved by the Monetary Authority of Singapore, arising from their transactions with non-residents, other members of the GES, and ACUs, in both the Singapore and overseas gold markets. Associate members of the GES will not be eligible for the concession.

## Personal income tax

(i) Tax rates

Between increasing the level of deductible reliefs and lowering tax rates across the board to afford reliefs from inflation, the Government has opted for the latter. This decision is based on sound principle and on precedent, first established by the Deputy Prime Minister as Minister of Finance, and upheld by the present Minister for Finance since 1970. This general reduction in personal tax rates gives relief to all without shrinking the tax-paying population.

Details of proposed reduction in individual income tax are shown in Appendix II to the Budget speech on page 154.

Every taxpayer will be given a reduction in tax ranging from 6.8 percent, depending on his tax bracket. The average reduction in tax is 16.1 percent.

The highest marginal rate remains at 55 percent, but the lowest marginal rate is now reduced to 4 percent. Taxpayers in the first and second tax brackets, therefore, enjoy the largest reductions in relative terms. Those in the first taxable bracket will, on average, pay only one percent of their incomes in tax. The others are given tax reductions commensurate with their bigger tax liabilities.

The new rates will take effect from Year of Assessment 1980.

The aim of the Government is to reduce the levels of personal income tax in the next 2-3 years until the maximum effective rate is no more than the company rate of income tax, i.e. 40 percent.

(ii) Relief for handicapped persons

If a taxpayer maintains a brother or sister who is incapacitated by physical or mental infirmity and who does not earn any income and continues to depend on the taxpayer, he will be entitled to claim a deduction of $750. The allowance is presently given only to parents of handicapped persons.

This relief is given only to taxpayers who maintain such a member of the family in the same household. The deduction may also be apportioned if more than one taxpayer maintain the same handicapped brother or sister. It will take effect from Year of Assessment 1980.

## Reaction to the Budget

The 1980 Budget has been well received by most Singaporeans who describe it as a Tax Cut Budget or a Joy Budget. Because of the across-the-board tax cuts in personal income tax most people welcome the budget as a give-away budget as every taxpayer at all levels is given a reduction in personal income tax payment for the Year of Assessment 1980. (See old & new rates compared in Appendix I.) There are more "cheers" than "tears" as cigarette manufacturers are perhaps the only group to spill tears over the Budget.

A summary of the tax changes and tax concessions appears as Appendix II.

### APPENDIX I

**Personal income tax**
**Old and new rates compared**

| Chargeable Income | | Old rate% | Old Tax payable | New rate% | New Tax payable | savings |
|---|---|---|---|---|---|---|
| On the first | 2,500 | 5 | 125 | 4 | 100 | 25 |
| On the next | 2,500 | 8 | 200 | 7 | 175 | 25 |
| On the first | 5,000 | | 325 | | 275 | 50 |
| On the next | 2,500 | 10 | 250 | 9 | 225 | 25 |
| On the first | 7,500 | | 575 | | 500 | 75 |
| On the next | 2,500 | 12 | 300 | 11 | 275 | 25 |
| On the first | 10,000 | | 875 | | 775 | 100 |
| On the next | 5,000 | 15 | 750 | 14 | 700 | 50 |
| On the first | 15,000 | | 1,625 | | 1,475 | 150 |
| On the next | 5,000 | 20 | 1,000 | 17 | 850 | 150 |
| On the first | 20,000 | | 2,625 | | 2,325 | 300 |
| On the next | 5,000 | 25 | 1,250 | 21 | 1,050 | 200 |
| On the first | 25,000 | | 3,875 | | 3,375 | 500 |
| On the next | 10,000 | 30 | 3,000 | 26 | 2,600 | 400 |
| On the first | 35,000 | | 6,875 | | 5,975 | 900 |
| On the next | 15,000 | 35 | 5,250 | 32 | 4,800 | 450 |
| On the first | 50,000 | | 12,125 | | 10,775 | 1,350 |
| On the next | 25,000 | 40 | 10,000 | 34 | 8,500 | 1,500 |
| On the first | 75,000 | | 22,125 | | 19,275 | 2,850 |
| On the next | 25,000 | 40 | 10,000 | 36 | 9,000 | 1,000 |
| On the first | 100,000 | | 32,125 | | 28,275 | 3,850 |
| On the next | 100,000 | 45 | 45,000 | 40 | 40,000 | 5,000 |
| On the first | 200,000 | | 77,125 | | 68,275 | 8,850 |
| On the next | 200,000 | 50 | 100,000 | 45 | 90,000 | 10,000 |
| On the first | 400,000 | | 177,125 | | 158,275 | 18,850 |
| On the next | 200,000 | 55 | 110,000 | 50 | 100,000 | 10,000 |
| On the first | 600,000 | | 287,125 | | 258,275 | 28,850 |
| over | 600,000 | 55 | | 55 | | |

### APPENDIX II

**Summary of tax changes and tax concessions**

**Tax changes**

*Withdrawal of protection for cigarettes and tobacco*

Excise duty on cigarette manufacture is raised from $4 to $9 per kilogram and import duty on cut rag is increased from $35 to $36 per kilogram.

**Tax concessions**

1. *Tax concessions for research and development*

Tax incentives for research and development to encourage manufacturers to develop new products and processes and to modify existing ones. (Double deduction for R & D expenditure, accelerated depreciation and investment allowance of the capital investment.)

2. *Capital allowances for plant and machinery*

Higher capital allowances for plant and machinery to encourage development of higher technology and greater automation. (An accelerated depreciation allowance for plant and machinery including computers and R & D equipment, and a more favourable accounting method for writing off equipment, i.e. changes from reducing balance method to straight line method.)

3. *Stamp duties*

Removal of certain duties and rationalising others at a single rate aimed at promoting the Republic's development as a financial centre. (Removal of stamp duties for Asian dollar and Singapore dollar loans, Asian currency unit off-shore loans, share certificates and standardisation of the duty on share transfer deeds to 0.2 percent.)

4. *Concession for offshore gold transactions*

To encourage the growth of the market the Minister removed the 40 percent tax on income derived from goal transactions with non-residents and replaced it with a 10 percent concessionary rate.

5. *Personal income tax*

(i) Tax rates
An across the board reduction in personal tax rates ranging from 6.8 percent to 19.9 percent.

(ii) Relief for handicapped person
A relief of $750 if the taxpayer maintains an incapacitated brother or sister.

# The 1980 Income Tax Changes in the Republic of South Africa

BY DR. ERWIN SPIRO

While pursuing a policy of more growth from greater strength, Senator O.P.F. Horwood, the Minister of Finance, when delivering his Budget speech, emphasized that tax concessions had to be adjusted to prevent the combination of inflation and a progressive tax system, the so-called "fiscal drag", from increasing the real tax burden on the community and thereby actually retarding economic growth. Adverting to the expectations of the taxpayer, however, the Minister of Finance asked him to heed Halifax's warning: *"Men should do with their hopes as they do with their tame fowl: cut their wings that they may not fly over the wall."*

## I. FURTHER CONCESSIONS

*Initial and investment allowances.* The existing initial and investment allowances, which are two of the principal incentive devices, will be extended for a further period of three years till June 30, 1982.

*Building costs of dwellings for employees.* To encourage participation by employers in the provision of housing for their employees, the presently existing ceiling on the deduction, for tax purposes, of the building costs of any one dwelling for a farmer's employee will be increased from R4,000 to R5,000. For other employers, the existing allowance of 25 percent of the expenditure incurred will be increased to 50 percent, with a maximum of R4,000 instead of the present R3,000. The revised allowances will apply to the cost of buildings, the erection of which commences on or after April 1, 1980.

*Lump sum distributions.* The maximum tax-free lump sum benefit paid out of a pension, provident or retirement annuity fund on or after March 1, 1980, will be increased from R45,000 to R60,000. A number of other allied adjustments will also be effected.

*Expenses incurred by the physically disabled.* The maximum deduction for tax purposes in respect of expenses incurred by the physically disabled will be increased from R600 to R1,200, and all other limitations will be removed.

*Married working women.* As rising costs prejudice the net income of the two-breadwinner family more than that of the single-breadwinner family, the tax-free portion of married women's income will be increased from R900 to R1,200.

## II. STRUCTURAL CHANGES

*Subscription shares.* The interest on subscription shares of building societies is currently tax-free on a maximum share investment of R150,000 per person (whether such person is the taxpayer or not). This concession appears to the Minister of Finance to be out of line with the far more modest amounts which may be invested tax-free in the Post Office, the Treasury and also in the form of tax-free indefinite period building shares and will now be restricted — to the obvious dismay of the building societies — to a maximum tax-free subscription share investment of R50,000 per taxpayer. To minimize inconveniences, the restriction will be phased in equal amounts over a period of three years.

*Loan levy.* There being no reason for the continuation of compulsory loans to the State as the necessary funds can be substituted for on a voluntary basis in the form of Government stock issues in the domestic market, all loan levies on individuals and companies will be abolished as from April 1, 1980.

*Fringe benefits.* Taxation of fringe benefits really means taxation of income in kind. Certain fringe benefits have always been subject to tax, and a new source of revenue is not envisaged. Differences of opinion relate mainly to the method of taxation and the date the tax should be instituted. There are now revised draft proposals, aiming at taxing all housing loans, entertainment allowances, private use of business cars, share participation schemes and low interest or interest free loans and the elimination of discrimination between the private and public sectors. The Minister of Finance intends to bring them into force from March 1, 1981.

*Single basic income tax rate for married and unmarried persons.* In future, the differentiation between unmarried and married persons will now be achieved, firstly, by allowing a smaller primary rebate to unmarried persons (see the examples under Tax Rebates) and, secondly, by increasing their tax by means of a 20 percent surcharge. The progression of the basic marginal rates of the normal income tax will be adjusted so that the maximum rate in respect of married persons is only reached at R40,000 and in respect of single persons, inclusive of the surcharge, at R28,000. In addition the maximum basic marginal rate will be decreased from the present 55 percent to 50 percent. Reference is made to Annexure — Table II.

*Tax rebates.* There will be a return to a system of tax rebates as was in force prior to 1972, in contrast to the system of diminishing income abatements applicable at present. The latter are deducted from the taxable income, reduced, however, as income increases whereas rebates are deducted from the tax regardless of the size of the taxable income (see *Bulletin* 328 (1971)). The existing combined abatement for medical expenses and insurance premiums will be separated. Insurance premiums will continue to qualify for rebate purposes, but as far as medical expenses are concerned, from the 1980/81 tax year, actual medical expenses up to a maximum amount of R1,000 will qualify as a deduction (in the case of persons over the age of 60 years up to a maximum amount of R2,000). As a result a person will only become liable to tax if his taxable income, after deduction of actual medical expenses, exceeds the following amounts:

| | |
|---|---|
| *Persons over the age of 60 years* | |
| unmarried | R3,000 |
| married | R4,000 |
| *Persons under the age of 60 years* | |
| unmarried | R1,500 |
| married | R2,500 |
| married with 1 child | R3,750 |
| married with 2 children | R5,000 |
| married with 3 children | R6,200 |
| married with 4 children | R7,166 |

## III. TAXATION OF BLACK PEOPLE

Last year the Minister of Finance pointed out that the equalization of the tax liability of whites, coloureds and Indians, on the one hand, and blacks, on the other, would extend over a period of three years. As in the case of other population groups, it is necessary also to grant relief in respect of black taxpayers. The threshold of liability for tax will, therefore, be increased from R1,200 to R1,800 per taxpayer, and the tax rate thereafter will be reduced by 20 percent. Reference is made to Annexure — Table I.

## IV. FUTURE LAW

*Initial and investment allowances.* There are certain controversies, but the Minister of Finance felt that the status quo should not lightly be changed and, therefore, directed the Standing Commission on Taxation to investigate the whole issue and to submit recommendations to him.

*Fringe benefits.* In view of the fact that the proposed measure is to apply only from March 1, 1981 (see II above), employers and employees have, according to the Minister of Finance, been afforded sufficient time to determine the effect of the proposals on their take-home earnings and to adapt to the new approach.

*Separate taxation of (working) wives.* Referring to fresh representations for the separate taxation of (working) wives, the Minister of Finance still did not see his way clear, both for reasons advanced by the Standing Commission on Taxation Policy and for practical and logistical reasons, to change over now to a system of separate assessments and, one may add, to a separate incidence of tax.

## V. RATES OF INCOME TAX (NORMAL TAX)

*Persons other than companies.* Persons other than companies are, in respect of the taxable income derived in the year of assessment ending on February 28, 1981, or June 30, 1981, whichever is applicable, subject to normal income tax at the rates contained in Annexure — Table II with a maximum basic marginal rate of 50 per cent and with the addition, in the case of unmarried persons, of a 20 percent surcharge on the tax. As mentioned earlier (sub II), the maximum rate will thus be reached where the taxable income exceeds R40,000 in the case of married persons and R28,000 in the case of unmarried persons.

*Companies.* The rates for companies in respect of taxable income derived in the Republic of South Africa in the year of assessment, that is the financial year ending during the twelve-month period from April 1, 1980 to March 31, 1981, are as follows:

(i) *taxable income derived otherwise than from mining:* 40 cents per R1. A surcharge of 5 percent of such tax is to be added to such tax. The effective rate is thus 42 cents per R1.

(ii) *taxable income derived from gold mining:*
(a) on any mine other than a post-1966 gold mine an amount determined in accordance with one of the formulae laid down plus a surcharge which is not payable in respect of certain assisted gold mines equal to 5 percent of the said amount;
(b) on post-1966 gold mines an amount determined in accordance with one of the formulae laid down plus a surcharge of 5 percent of the said amount;
(c) in the form of excess recoupments over capital expenditure accruing to companies which are or have been gold mining companies the average rate of tax as determined in accordance with the Act or 35 cents per R1, whichever is higher.

(iii) *taxable income derived from mining for diamonds:* 45 cents per R1 plus a surcharge of 5 percent of such amount;

(iv) *taxable income derived from mining operations other than mining for gold or diamonds (or natural oil):* the position is the same as in the case of a non-mining company (see (i) above);

(v) *taxable income derived from mining for natural oil:* in respect of taxable income derived from mining for natural oil (excluding gas) normal tax at the rate applying to non-mining income plus an amount equal to 40 percent of the balance remaining after deducting the normal tax and in respect of taxable income derived from mining for natural oil in the form of gas normal tax at the rate applying to non-mining income, the normal and additional taxes chargeable being subject to such a reduction as the Minister of Mines, in consultation with the Minister of Finance, may determine. Where sulphur, salt or any other mineral is won in the course of mining for natural oil, the income derived from the mining of sulphur, salt or other mineral is deemed to be derived from mining for natural oil.

*Summary of reductions.* The reductions may be summarized as follows:

(i) in the case of all persons; the disappearance of the loan levy, that is 10 percent;
(ii) in the case only of persons other than companies: the reduction of the maximum rate from 55 to 50 per cent, such maximum rate being reached now at R40,000 (instead of before R30,000) in the case of married persons and at R28,000 (instead of before R22,000) in the case of unmarried persons.

## VI. RATE OF OTHER TAXES CONTAINED IN THE INCOME TAX ACT

*Non-resident shareholders' tax.* The non-resident shareholders' tax is 15 percent of the amount of the dividend or interim dividend in question.

*Undistributed profits tax.* The undistributed profits tax is 33 1/3 cents on every R1 by which the 'distributable income' as defined exceeds the amount of dividends distributed during the 'specified period' as defined.

*Non-residents' tax on interest.* The non-residents' tax on interest is 10 percent on the amount of the interest in question.

*Donations tax.* The donations tax is at progressive block rates, the block exceeding R90,000 being taxable at the rate of 25 percent.

### ANNEXURE – TABLE I (BLACK TAXATION)

| Taxable income | Rates of tax |
|---|---|
| Where the taxable income— does not exceed R1,800 | Nil |
| exceeds R 1,800 but does not exceed R 2,100 | R0.00 plus R0.24 for each completed amount of R30 by which the taxable income exceeds R1,800; |
| exceeds R 2,100 but does not exceed R 3,120 | R2.40 plus R0.72 for each completed amount of R30 by which the taxable income exceeds R2,100; |
| exceeds R 3,120 but does not exceed R 4,140 | R26.88 plus R1.68 for each completed amount of R30 by which the taxable income exceeds R3,120; |
| exceeds R 4,140 but does not exceed R 5,160 | R84.00 plus R2.40 for each completed amount of R30 by which the taxable income exceeds R4,140; |
| exceeds R 5,160 but does not exceed R 6,180 | R165.60 plus R3.12 for each completed amount of R30 by which the taxable income exceeds R5,160; |
| exceeds R 6,180 but does not exceed R 7,200 | R271.68 plus R3.36 for each completed amount of R30 by which the taxable income exceeds R6,180; |
| exceeds R 7,200 but does not exceed R 8,220 | R385.92 plus R3.84 for each completed amount of R30 by which the taxable income exceeds R7,200; |
| exceeds R 8,220 but does not exceed R 9,240 | R516.48 plus R4.80 for each completed amount of R30 by which the taxable income exceeds R8,220; |
| exceeds R 9,240 but does not exceed R10,260 | R679.68 plus R5.28 for each completed amount of R30 by which the taxable income exceeds R9,240; |
| exceeds R10,260 but does not exceed R11,280 | R859.20 plus R6.24 for each completed amount of R30 by which the taxable income exceeds R10,260; |
| exceeds R11,280 but does not exceed R12,300 | R1,071.36 plus R6.72 for each completed amount of R30 by which the taxable income exceeds R11,280; |
| exceeds R12,300 but does not exceed R13,320 | R1,299.84 plus R7.68 for each completed amount of R30 by which the taxable income exceeds R12,300; |
| exceeds R13,320 but does not exceed R14,340 | R1,560.96 plus R8.16 for each completed amount of R30 by which the taxable income exceeds R13,320; |
| exceeds R14,340 but does not exceed R15,360 | R1,838.40 plus R8.88 for each completed amount of R30 by which the taxable income exceeds R14,340; |
| exceeds R15,360 but does not exceed R16,380 | R2,140.32 plus R9.60 for each completed amount of R30 by which the taxable income exceeds R15,360; |
| exceeds R16,380 but does not exceed R17,400 | R2,466.72 plus R10.32 for each completed amount of R30 by which the taxable income exceeds R16,380; |

| Taxable income | Rates of tax |
|---|---|
| Where the taxable income— | |
| exceeds R17,400 but does not exceed R18,420 | R2,817.60 plus R10.80 for each completed amount of R30 by which the taxable income exceeds R17,400; |
| exceeds R18,420 but does not exceed R19,440 | R3,184.80 plus R10.80 for each completed amount of R30 by which the taxable income exceeds R18,420; |
| exceeds R19,440 but does not exceed R20,460 | R3,552.00 plus R10.80 for each completed amount of R30 by which the taxable income exceeds R19,440; |
| exceeds R20,460 but does not exceed R21,480 | R3,919.20 plus R11.04 for each completed amount of R30 by which the taxable income exceeds R20,460; |
| exceeds R21,480 but does not exceed R22,500 | R4,294.56 plus R11.04 for each completed amount of R30 by which the taxable income exceeds R21,480; |
| exceeds R22,500 but does not exceed R23,520 | R4,669.92 plus R12.00 for each completed amount of R30 by which the taxable income exceeds R22,500; |
| exceeds R23,520 but does not exceed R24,540 | R5,077.92 plus R12.00 for each completed amount of R30 by which the taxable income exceeds R23,520; |
| exceeds R24,540 but does not exceed R25,560 | R5,485.92 plus R12.72 for each completed amount of R30 by which the taxable income exceeds R24,540; |
| exceeds R25,560 but does not exceed R26,580 | R5,918.40 plus R13.20 for each completed amount of R30 by which the taxable income exceeds R25,560; |
| exceeds R26,580 but does not exceed R27,600 | R6,367.20 plus R13.68 for each completed amount of R30 by which the taxable income exceeds R26,580; |
| exceeds R27,600 but does not exceed R28,020 | R6,832.32 plus R13.92 for each completed amount of R30 by which the taxable income exceeds R27,600; |
| exceeds R28,020 . . . . . . . . . . . . . . . . . . . . | R7,027.20 plus R14.40 for each completed amount of R30 by which the taxable income exceeds R28,020. |

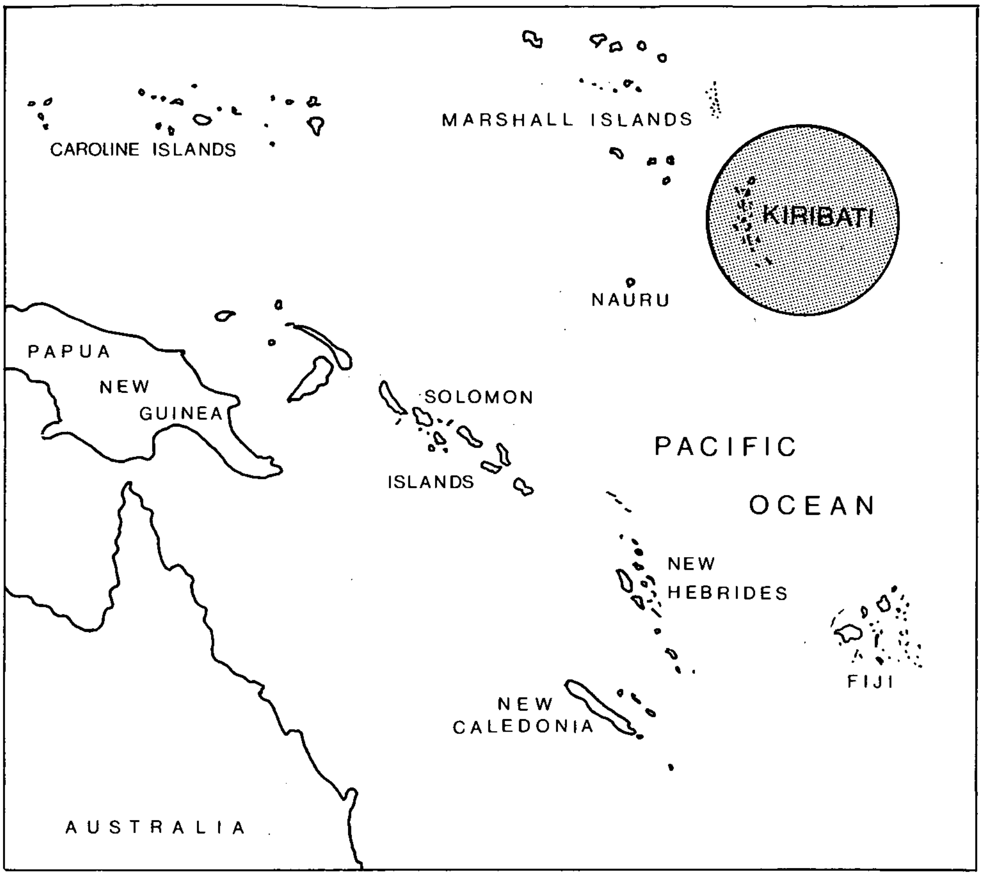
## ANNEXURE – TABLE II
## (WHITES, COLOUREDS AND INDIANS)

| Taxable income | Rates of tax |
|---|---|
| Where the taxable income— | |
| does not exceed R6,000 . . . . . . . . . . . . . . . | .8 percent of each R1 of the taxable income; |
| exceeds R 6,000 but does not exceed R 7,000 | R480 plus 10 percent of the amount by which the taxable income exceeds R6,000; |
| exceeds R 7,000 but does not exceed R 8,000 | R580 plus 12 percent of the amount by which the taxable income exceeds R7,000; |
| exceeds R 8,000 but does not exceed R 9,000 | R700 plus 14 percent of the amount by which the taxable income exceeds R8,000; |
| exceeds R 9,000 but does not exceed R10,000 | R840 plus 16 percent of the amount by which the taxable income exceeds R9,000; |
| exceeds R10,000 but does not exceed R11,000 | R1,000 plus 18 percent of the amount by which the taxable income exceeds R10,000; |
| exceeds R11,000 but does not exceed R12,000 | R1,180 plus 20 percent of the amount by which the taxable income exceeds R11,000; |
| exceeds R12,000 but does not exceed R13,000 | R1,380 plus 22 percent of the amount by which the taxable income exceeds R12,000; |
| exceeds R13,000 but does not exceed R14,000 | R1,600 plus 24 percent of the amount by which the taxable income exceeds R13,000; |
| exceeds R14,000 but does not exceed R15,000 | R1,840 plus 26 percent of the amount by which the taxable income exceeds R14,000; |
| exceeds R15,000 but does not exceed R16,000 | R2,100 plus 28 percent of the amount by which the taxable income exceeds R15,000; |
| exceeds R16,000 but does not exceed R18,000 | R2,380 plus 30 percent of the amount by which the taxable income exceeds R16,000; |
| exceeds R18,000 but does not exceed R20,000 | R2,980 plus 32 percent of the amount by which the taxable income exceeds R18,000; |

Where the taxable income—

| | |
|---|---|
| exceeds R20,000 but does not exceed R22,000 | R3,620 plus 34 percent of the amount by which the taxable income exceeds R20,000; |
| exceeds R22,000 but does not exceed R24,000 | R4,300 plus 36 percent of the amount by which the taxable income exceeds R22,000; |
| exceeds R24,000 but does not exceed R26,000 | R5,020 plus 38 percent of the amount by which the taxable income exceeds R24,000; |
| exceeds R26,000 but does not exceed R28,000 | R5,780 plus 40 percent of the amount by which the taxable income exceeds R26,000; |
| exceeds R28,000 but does not exceed R30,000 | R6,580 plus 42 percent of the amount by which the taxable income exceeds R28,000; |
| exceeds R30,000 but does not exceed R32,000 | R7,420 plus 44 percent of the amount by which the taxable income exceeds R30,000; |
| exceeds R32,000 but does not exceed R34,000 | R8,300 plus 46 percent of the amount by which the taxable income exceeds R32,000; |
| exceeds R34,000 but does not exceed R36,000 | R9,220 plus 47 percent of the amount by which the taxable income exceeds R34,000; |
| exceeds R36,000 but does not exceed R38,000 | R10,160 plus 48 percent of the amount by which the taxable income exceeds R36,000; |
| exceeds R38,000 but does not exceed R40,000 | R11,120 plus 49 percent of the amount by which the taxable income exceeds R38,000; |
| exceeds R40,000 . . . . . . . . . . . . . . . . . . . | R12,100 plus 50 percent of the amount by which the taxable income exceeds R40,000; |

# The Tax System of Kiribati[1]




## I. INTRODUCTION

On July 12, 1979 the Gilbert Islands, which until that date had been a colony of the United Kingdom, became independent under the name of the Republic of Kiribati. Its total surface is no more than 655 square kilometres (approximately one quarter of the size of Luxembourg) although its islands are spread over a part of the Pacific which measures more than 4,000,000 square kilometres (about twice the surface of Greenland).[2] Its capital city is Bairiki on the island of Tarawa.

The Republic of Kiribati consists of three groups of islands:

*The Gilberts Group:*
Makin, Butaritari, Marakei, Abaiang, Tarawa (centre of government administration), Maiana, Abemama, Kuria, Aranuka, Nonouti, Tabiteuea (North and South), Beru, Nikunau, Onotoa, Tamana, Arorae, Banaba.

*The Line Group:*
Tabuaeran (Washington), Teraina (Fanning), Christmas (Northern Line Group), Malden, Starbuck (Central Line Group), Vostock, Caroline, Flint (Southern Line Group).

*The Phoenix Group:*
Canton, Orona (Hull), Nikumaroro (Gardner), Moara (Sydney), Phoenix, Birnie, Mckean, Enderbury.

## II. POLICY OBJECTIVES

### A. Tariff policy

Import tariffs are of particular importance in an economy in which imports constitute a large proportion of local consumption and investment. They influence consumption patterns, the viability of local businesses and the distribution of real incomes. The revenue from import tariffs accounts for 40 percent of locally raised revenue.

The level of tariffs may thus have a considerable effect on the achievement of objectives.

The following principles have been established for guidance in setting tariffs at levels which will assist in establishing a sound long term economic structure and in achieving the objectives of the "National Plan".

(a) Duties should promote the most beneficial economic structure in the long term.
(b) Where compatible with (a), local production should be encouraged by tariff measures.
(c) Where compatible with (b), basic consumer necessities should be subject to minimal duties.
(d) Luxury consumer goods should be subject to high rates of duty for revenue purposes.

1. We are indebted to Mr. P. Jackson of the Kiribati Ministry of Finance for most of the information published in this note.
2. Wereldmarkt, July 10, 1979 at 8.

(e) Where compatible with (d), goods which are important in the consumption of rural people should be subject to minimal duties.
(f) Taking into account (a), raw and semi-processed goods should generally be subject to lower duties than processed goods.
(g) Goods conducive to education and health should be subject to minimal duties.

In the Budget of 1978, amongst other measures, the duties on bicycles, sewing machines and lamp oil were eliminated, duties on cotton fabrics reduced and on poultry and eggs increased.

### B. Recurrent revenue and investment

The recurrent budget has been financed entirely from local revenue, with a substantial surplus in most years which has been used to build the Revenue Equalisation Reserve Fund. With the expiry of phosphate during this year, the position changes radically, which can be seen from Table 1. Local revenue will be substantially below present expenditure.

Arrangements for funding the deficit have been made with the United Kingdom under the "Independence Financial Settlement", but this settlement allows for the utilisation of part of the Reserve Fund interest per year. It is intended to manage the Reserve Fund so as to slow down, as far as possible, the depreciation of its capital value in real terms. The Agreement provides for a review of financial arrangements in 1982.

### C. Foreign investment

The British Phosphate Commissioners (BPC), a partnership of the British, Australian and New Zealand Governments, have played a dominant role in the economy of Kiribati for most of this century through their phosphate mining operation on Banaba.

The BPC has been the main source of overseas earnings, the main source of government revenue and a substantial employer. The consequences of the termination of phosphate mining on Banaba were realised some time ago when it was decided to build up the Revenue Equalisation Reserve Fund with the income derived from phosphate mining.

Besides the BPC, the only significant foreign investment has been in copra plantations, banking and fuel supplies. Fanning Island Plantations owns the islands of Fanning and Washington and operates copra plantations employing about 135 people. Total employment by foreign owned companies, excluding BPC, amounts to about 175 people.

The main constraints on the growth of foreign investment have been the remoteness of the country from major markets, the shortage of land and the lack of skilled manpower. Little effort has been made to promote foreign investment.

With the loss of phosphate revenue the Government is now concerned to build up economic activity in the country and is taking a more active role in the promotion of foreign investment. A number of sectors have been identified as suitable for foreign investment, the most important being fisheries, tourism and mineral exploration.

Foreign investment is specifically to be encouraged in order to develop the economic strength of the nation after the end of phosphate mining. Some of the objectives of this foreign investment will be to promote the development of new and existing industries based on marine and other resources, and to encourage foreign business investment in Kiribati.

Foreign investment will particularly be sought for the development of the country's natural resources and in the commercial and manufacturing sectors. The most suitable projects for foreign investment are likely to be those that:

(a) provide employment for local people;
(b) expand exports or reduce imports;
(c) require large capital sums in joint ventures, where the government contribution can be in the form of the resource to be exploited;
(d) require foreign technology or management to ensure success (e.g. in mineral exploration);
(e) require foreign participation to ensure access to markets.

Further aims regarding foreign investment are:

(a) to ensure local participation in significant ventures involving foreign capital;
(b) to ensure maximum local benefit in employment, overseas earnings and government revenue from ventures involving foreign capital;
(c) to minimise any adverse social effects arising from foreign investment.

## III. THE TAX SYSTEM

> There are no provisions for such taxes as Wealth tax, Gift tax or Corporation tax, neither is there a levy for Estate duty.

### A. Income tax

Income tax is charged on the income earned by a resident, which accrues in, is derived from or is received in Kiribati, and, in the case of a non-resident, that income which accrues in or is derived from Kiribati.

Income tax is charged on all of the following:

(a) gains or profits from:
  (i) any business, for whatever period of time carried on (provided that a husband and wife carrying on a business together shall not be treated as partners in relation to each other for any purpose of this Ordinance);
  (ii) any employment or services rendered;
  (iii) any right granted to any other person for the use or possession of any property;
(b) dividends, interest and discounts;
(c) any pension, charge, annuity or alimony;

(d) any amount deemed to be his income under this Ordinance.

> **Note**
>
> Any income directly derived from the sale of copra shall be exempt from Income tax, but instead a charge of 25 percent in respect of "Copra tax" shall be levied.

The rates of tax are as follows:

| | Australian $ | | % |
|---|---|---|---|
| First | 500 | — | 9 |
| next | 500 | — | 12 |
| next | 1,000 | — | 21 |
| next | 1,000 | — | 30 |
| next | 1,500 | — | 39 |
| next | 1,500 | — | 45 |
| exceeding | 6,000 | — | 50 |

The following outgoings and expenses are allowable when ascertaining income in respect of individuals, partnerships or companies:

(a) Interest paid upon borrowed money, where the said money is employed in the production of income chargeable to tax (providing the loan was not for acquiring a source of income outside Kiribati).
(b) Rent paid by any tenant of land or buildings occupied for the purpose of acquiring the income.
(c) Sums expended on the necessary repair of premises, plant, machinery, etc.
(d) Bad debts incurred (in the course of a business).
(e) Contributions to approved pension schemes.
(f) Certain expenditure of a capital nature for the purposes of a business.
(g) Any amount paid by way of alimony or allowance under a decree of divorce.
(h) Any loss incurred, and where it cannot be wholly "set-off" against income from other sources for that year, the remainder shall be carried forward and deducted in ascertaining total income for subsequent years in succession.

In addition to Income tax there are one or two specific taxes, i.e.:

*Phosphate taxation* (as per the government ordinance as follows): Of the net proceeds per ton of phosphate minerals exported from the Republic, the British Phosphate Commissioners shall in any phosphate year (ending 30/6) pay a phosphate tax. Phosphate tax per ton shall be calculated in with the Table contained in the Schedule, ranging from $3.9045 tax on $4.40 proceeds per ton to $5.6039 tax on $6.40 proceeds per ton.

*Landowners taxation*: This is a land tax assessed, levied and collected by the Council within whose area of authority the land is situated. The amount of tax to be imposed is determined by the amount of Revenue required to be raised from this source for the Council Fund.

### B. Customs duties

Customs duties are levied on both goods imported into and exported out of Kiribati. The rates are either ad valorem or specific and are indicated in the Customs Tariff.

## IV. REVENUE

The Government's internal revenue for the years 1973 through 1979 and the forecasted figures for 1980 through 1982 are set out in Table 1.

**Table 1**

| | 1973 | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 |
|---|---|---|---|---|---|---|---|---|---|---|
| Direct taxes | 301 | 353 | 592 | 700 | 885 | 880 | 1,060 | 820 | 880 | 935 |
| Indirect taxes | 1,545 | 2,312 | 1,889 | 2,520 | 2,818 | 2,510 | 2,553 | 2,370 | 2,410 | 2,520 |
| Phosphate taxes | 2,910 | 10,603 | 22,783 | 9,500 | 8,301 | 8,082 | 6,544 | – | – | – |
| PWD overheads | – | – | – | – | – | 450 | 300 | 320 | 340 | 360 |
| Tuna licences | – | – | – | – | – | 259 | 1,000 | 1,360 | 1,430 | 1,500 |
| Other income | 741 | 1,172 | 1,091 | 1,152 | 1,947 | 2,807 | 3,140 | 3,390 | 3,630 | 3,850 |
| Total revenue | 5,497 | 14,440 | 26,355 | 13,872 | 13,951 | 14,988 | 14,597 | 8,260 | 8,690 | 9,165 |

# Ireland: BUDGET 1980

**"It's good news for non-drinking, non-smoking, non-driving taxpayers" (Irish Times, February 28, 1980 at 15)**

The following is an extract of the text of the Budget statement by the Minister for Finance, Mr. O'Kennedy, pronounced on February 27, 1980.

*Prudent management of the public finances and improving the climate for economic development are normal priorities for a Minister for Finance when drawing up his Budget. This obligation takes on a special significance at a time of international economic recession, such as we now experience.*

*Because the international recession has had a particularly damaging impact on our energy dependent open economy, there is a new burden to be carried today. We must all ensure that this new burden, unwelcome though it may be, will be shouldered evenly by all who can bear it. A progressive economic policy can only be implemented through the collective commitment and action of all sections of the community. It must be built on the firm foundation of a caring and sharing society, so that in overcoming the immediate problems, we emerge more determined to achieve a healthy social and economic order which we can all respect.*

*My proposals today, and Government policy throughout the year, will be firmly directed towards those ends.*

*The experience of last year indicates that we have found it difficult as a nation, in a period of growing prosperity, to adjust to the new reality of international economic recession.*

*But adjust we must, and my Budget proposals today are intended to encourage that adjustment in our individual and national interest. The pursuit of social justice in a basically healthy economy, beset as it may be by serious difficulties, has been a guiding principle for the Government in adopting the proposals which I will outline. I hope that they will evoke a positive and helpful response at this critical time in our national development. Our renewed determination, following the dramatic upsets of the past year, to achieve the objectives of equity and a proper balance in our national finances will not yield immediate results in the year ahead, but it will make a major contribution towards positive progress in that direction.*

*There is an urgent need to reduce the balance of payments deficit and the level of Exchequer borrowing. In seeking to reduce the level of borrowing, the Government have concentrated on curbing the growth of public expenditure, so as to ensure that taxpayers will be called upon to contribute only to absolutely essential services. We must see to it that the taxpayer's money is used effectively and in a manner that he or she will fully endorse. This will also ensure that the general burden of taxation is kept to the minimum consistent with economic and social priorities.*

*I will return to both of these themes later, but first I wish to review the economic developments in 1979. These comments will be brief because Deputies have already received a copy of the paper "Economic Background to the Budget, 1980".*

•••

## TAXATION

I turn now to the subject of taxation. The over-all level of taxation in Ireland, at 34 percent of GNP in 1978, compared with an average of 40 percent for the other EEC countries. This relatively low level of taxation in Ireland has been made possible only by large-scale borrowing over the past five years to finance current services.

The Government is fully committed to devising an equitable tax system, as between each taxpayer and each section of the community. It is not possible to allow each section the tax system of its choice, nor can a complex tax system be changed all at once. The Government will endeavour to ensure that taxpayers will recognize that no one is being disproportionately burdened and, particularly, that no one, by evasion, passes on his burden to another.

Steps have already been taken in the last two Budgets to improve the position of low income taxpayers, in particular by means of large increases in the personal allowances. The proposals in this Budget will advance the Government's objectives significantly.

The Government-ICTU Working Party on Taxation has devoted considerable time to devising acceptable and factual bases of comparison of the distribution of the tax burden. These are but the initial steps in tackling the complexities of the matter.

In order to assist the Government to assess the problem, objectively, and to design an equitable tax system, the Taoiseach has proposed a full-scale Commission on Taxation. The Government envisages that the Commission would discharge its task with all possible speed and might, by arrangement, provide interim reports on specific tax areas. Significant changes need not await the conclusions of the Commission, as today's Budget measures will show.

Within the obvious constraints that apply this year, my tax proposals should demonstrate the Government's commitment to equity in the tax system in a manner consistent with the economic and social priorities we must pursue.

## PERSONAL INCOME TAX

I will deal first with personal income tax. Of all taxes, personal income tax has most notably become a cause of widespread public unrest and dissatisfaction. I cannot in my Budget resolve all the problems associated with income tax but, when I have finished, I hope it will be clear that I have gone a long way towards an acceptable tax system — indeed, probably further than most people would reasonably expect, in the present circumstances. I am satisfied that the need to give justice and fairplay to income taxpayers requires that substantial measures be taken now rather than later.

In principle, income tax is a fundamentally fair tax system. Its essence is that each taxpayer pays, according to his means, on a common basis with everybody else in the same position, and that those who are better off pay more by an appropriate amount. The tax code also has a wide range of allowances and reliefs to cater for a varying range of social and family circumstances.

It is when the tax system is allowed to drift away from the basic principle I have outlined that the public's notion of fairness and equity is offended and disquiet about the tax system begins to mount. This is an issue which must be faced and resolved.

There are four main problems to which my proposals must address themselves:

- First of all, in the light of the recent Supreme Court decision, I have to deal with the taxation of married couples, particularly those where both husband and wife are earning.
- Next, I have to tackle the higher tax burden imposed on an increasing number of taxpayers in recent years, because income increases have attracted higher rates of tax.
- Thirdly, I think there is a need to give further reliefs to the less privileged taxpayers — those with low incomes, and, particularly, those with social and physical handicaps.
- Finally, there has been increasing unrest caused by the difference between the basis of assessment applied to wage and salary earners on PAYE and that applied to other taxpayers such as self-employed. These, as a general rule, pay tax based on profits of the accounting period ending in the preceding income tax year.

### Married taxpayers

With regard to the taxation of married couples, the Government is satisfied, in the light of recent developments, that nothing less than substantial changes in income taxation will now suffice. We intend, therefore, to implement our undertaking to alleviate the taxation of married couples.

A narrow approach towards effecting the minimum changes to meet the Supreme Court's decision would lead to unjustifiable discrimination against the one income family particularly where a married woman elects to care for the family on a full time basis at home rather than take up work outside the home.

Even in cases where both spouses are working, their tax liability, if nothing were done, would vary depending on how incomes were divided between them. There would also be considerable scope for tax avoidance by self-employed and better-off taxpayers, who could now attempt to take advantage of the Court's decision and arrange for both spouses to have an income designed to minimise liability for tax.

To implement the basic principle that taxpayers, with the same income and the same family and social circumstances should pay the same amount of tax, the Government has decided to implement now in full our longer-term plans for income-splitting.

This means, in effect, that all married couples, whether with one, or two, incomes, will have the benefit of double the personal allowance and rate bands applicable to single persons.

The Government is reinforced in its view that this represents a major and much needed social advance in the tax system by the views expressed by such representative bodies as the Irish Congress of Trade Unions. The Government believes that the introduction of this principle accords with the general needs and wishes of the community, notwithstanding the cost and the inevitable measure of tax redistribution involved.

The main personal allowances have been increased, substantially, in each of the past two years and, even if unchanged, would still be higher in real terms than they were in 1977.

### Employees

However, I am providing a special Schedule E employee allowance of £400 for each PAYE taxpayer in order to improve the tax progression for these taxpayers, and also to take account of the fact that the self-employed, generally, have at present the advantage of paying tax on a previous year basis.

I intend to exclude from this provision those Schedule E taxpayers in a position to control their own remuneration or that of their spouses, for example directors of proprietary companies. This Schedule E employee allowance is also intended to take account of the case made by ICTU that the present general scheme of allowances discriminates against employees and in favour of other taxpayers. Where an eligible husband and wife are both earning, this allowance will apply to each income. On the other hand, as a consequence of the introduction of income-splitting, the working wife allowance is being abolished.

### Adjustment to inflation

The higher rates of tax — or tax bands — now apply at unduly low rates of pay. This has occurred largely because, over the years, the value of the tax bands has not kept pace with inflation. Income taxation has become too progressive. Relatively high marginal tax rates clearly contribute to inflation and affect the attitude to work and attendance at work.

I have decided to tackle this problem as effectively and as fundamentally as I can. I propose, therefore, to raise the income levels at which the tax rates from 35 percent upwards apply.

The new rate structure will be as follows:
The first £1,000 of taxable income

for single persons and £2,000 for married persons will be at a rate of 25 percent; the next £4,000 for single persons and £8,000 for married persons will be at 35 percent; the next £2,000 for single persons and £4,000 for married persons will be at 45 percent; the next £2,000 for single persons and £4,000 for married persons will be at a new rate of 55 percent; and the balance of taxable income, that is above £9,000 for single persons and £18,000 for married persons, will be taxed at a rate of 60 percent.

The special allowance for PAYE taxpayers will have the effect of raising the point of application of the 25 percent and higher tax bands by a further £400, or by a further £800 where an eligible married couple are both earning.

A male industrial worker on, say, just over £100 a week will get relief of about £150 if he is single and £230 if he is married. If his wife also works and earns the average industrial female wage, the total relief for the couple will be about £500 or over 20 percent of their tax bill.

At present a married PAYE earner whose wife does not work may move from the standard, or 35 percent rate, to 45 percent at £122 per week. As a result of may proposals, this will not now happen until his earnings reach not less than £243 per week. The corresponding figure for single persons is raised from £100 to £125 a week.

The new structure, at one stroke, will bring over 180,000 taxpayers, or nearly two-thirds of those at present liable at higher rates, down to the lower standard rate band.

Tables which are circulated with my Financial Statement will show the relief which is granted to different categories of taxpayers.

It may appear that the distribution of tax relief unduly favours married couples with higher incomes, but this is an unavoidable consequence of observing the Supreme Court decision and of implementing income-splitting in full.

In broad terms, a relief given to a single person is doubled for married couples. Consequently, unless single persons on relatively modest incomes were to have their income tax burden increased, married couples with high incomes had to obtain substantial tax relief. The Government were faced with a situation in which the income of the average single male industrial worker had in many cases brought him into the 45 percent tax band. To remedy this situation, it was necessary to widen the standard rate tax band for single people — with a resultant double benefit for married couples.

The following is an example of the effect of my proposals on a married couple where the husband is earning £8,000 and his wife, who also works, is earning £4,000. Between them, because both are working, they have an income of about twice the average income for single workers. In 1979/80 they paid much more than twice the average tax of single persons and the top rate of 60 percent applied to part of their incomes. Their top rate of tax will now be reduced to 35 percent and the amount of tax they pay will be twice that of two single persons each earning half their combined income of £12,000 — their tax will be reduced by over £1,300. Under my proposals, much the same

## HIGHLIGHTS OF THE IRISH BUDGET 1980

– The 20 percent VAT rate is increased to 25 percent from May 1, 1980.

– Following a recent court case declaring certain tax provisions unconstitutional, married couples may be assessed separately as single persons. There is an option for joint assessment whereby double the single allowance and double the tax bands for single persons is applicable. The single allowance is £1,115 and the tax rates for 1980/81 are:

| *Single persons* | *Married couple-joint assessment* |
|---|---|
| 25 percent on first £1,000 | on first £ 2,000 |
| 35 percent on next £4,000 | on next £ 8,000 |
| 45 percent on next £2,000 | on next £ 4,000 |
| 55 percent on next £2,000 | on next £ 4,000 |
| 60 percent above £9,000 | above £18,000 |

– New special allowance of £400 for each PAYE employee except proprietory directors.

– Allowance for a child reduced by £23 to £195; allowances for one-parent families and blind persons doubled to £500 and £330 respectively.

– Exempt compensation for loss of employment increased from £3,000 to £6,000.

– The burden of taxation on farmers is increased. A resource tax of £3.50 for every £1 of rateable value in respect of holdings of £70 rateable value and over is introduced from April 6, 1980. The notional basis of assessment to income tax is abolished and replaced by the normal accounts basis. Furthermore, accelerated capital allowances for plant and machinery are restricted to 30 percent of net farm profit.

– Special rate of corporation tax of 25 percent for manufacturing companies is extended to December 31, 1980 where necessary conditions are satisfied.

– Stock relief is extended for a year — 1980/81 for income tax and accounting periods ending in the year to April 5, 1980 for corporation tax.

– Deductions for business expenses restricted to 50 percent of the taxpayer's taxable profits.

– Rises in excise duties include 20p per gallon on petrol, diesel and LPG and 40p per bottle on table wine.

relief will now be given to a single income family.

The net result of the Budget proposals will be that the burden of income tax for nine out of ten single people on PAYE will now be less than it was in 1977/78. In the case of all married couples on PAYE, the burden will now be less than at any time since the introduction of the present unified system of income tax in 1974/75. For married couples generally, the income tax structure will be at least comparable with that in the U.K. and, for the vast majority of taxpayers on lower incomes, whether single or married, it will be significantly better.

### Subsidiary deductions

I now come to deal with less privileged taxpayers. I am concerned that liability to income tax can apply to persons on very low incomes, particularly young people just starting work and casual or part-time workers. I cannot solve this problem completely but I am happy to go a long way in that direction by introducing complete tax exemption limits for people on low incomes, including those affected by sickness and unemployment. The exemption limits will be £1,700 for single and widowed persons and £3,400 for married persons. There will also be marginal relief at a rate of 60 percent for taxpayers with incomes just above the exemption limits. As a result of this proposal, 75,000 persons who would otherwise pay tax this year will now not do so.

A single person on £33 per week will be relieved of all his tax amounting to £146 per year. A married couple on £66 per week will get full relief of £300 a year.

The Government are particularly aware of the difficulties and anxieties experienced by many old persons in completing their income tax returns and complying with their tax obligations generally. In many cases this is out of all proportion to the ultimate liability involved. For this reason, I propose to raise the age exemption limits to £2,000 and £4,000 respectively for single and married persons aged 65 years and over. Special exemption limits of £2,500 and £5,000 will be introduced for persons aged 75 years and over. These limits will remove 8,000 old persons from the tax net, bringing to 83,000 the number of low-income taxpayers removed from liability. Marginal relief will benefit many more.

In 1969, an allowance was introduced to cover the case in which an individual, or his wife, is totally incapacitated throughout the year of assessment and a person is employed for the purpose of taking care of the incapacitated persons. I propose to double this allowance to £330.

I also propose to increase the allowance for incapacitated children to double the normal child allowance.

A special allowance of £250 was introduced last year for one-parent families which consist of a widowed person, a deserted spouse or an unmarried parent with a dependent child or children. This was widely welcomed. I am satisfied that this allowance fulfils a genuine social need and I propose to double it, to £500.

The allowance for blind persons has been increased since it was introduced in 1971. I propose to double this allowance also to £330. In the case of a married couple, both of whom are blind, this allowance will apply to each spouse.

### Welfare benefits

The Government have been reconsidering the planned taxation of short-term social welfare benefits from April 6th next, which was provided for last year. The new tax exemption which I have proposed for those on lower incomes would reduce any revenue gain from the effects of making short-term social welfare benefits taxable and, moreover, the new tax structure will improve the incentive to work. In these circumstances the Government have come to the conclusion that the proposal should not be implemented. This change in plans will cost £8.5 million in 1980. The necessary amendment will be included in the Finance Bill.

In drawing up my proposals I had particular regard to the representations made by ICTU. In many respects the effects of my proposals on individual taxpayers are quite similar to those of the ideas they had put forward. Where there are differences, they are not, I feel, major ones.

The total cost of the changes in allowances, rate bands and exemptions is £131.5 million in 1980 and £227 million in a full year. Including the decision not to tax short-term social welfare benefits, I have now deducted £140 million in 1980 from the revenue side of the Budget.

### Self-employed

The fourth major element in my income tax package this year is to devise more uniform treatment of employed and self-employed persons.

Self-employed persons are normally charged to income tax in any year on the basis of the profits of the accounting period ending in the preceding income tax year. In present circumstances, when both incomes and profits are rising rapidly in money terms each year, this results in a substantial advantage to the self-employed compared with taxpayers in the PAYE sector, where tax is charged on current earnings. It would be in the interest of greater equity if both sectors were brought to an equivalent basis of assessment as soon as possible. Where there are considerable difficulties in doing this, I am examining the matter with a view to bringing about the changes that are necessary.

I have already announced that I am giving a special PAYE allowance of £400 to compensate PAYE taxpayers for the generally more favourable basis of assessment applied to other taxpayers. I now propose also to change the dates of payment for Schedule D tax on self-employed. At present this tax is payable in two instalments on September 1st and January 1st in the year of assessment. Subject to an exception to which I shall come later, I propose to provide that all income tax other than PAYE will now be payable in one instalment on October 1st in the year of assessment.

This change will yield £24 million in 1980.

### Supreme Court judgement

As I have outlined, my tax proposals for 1980/81 take fully into account the Supreme Court decision on the taxation of married couples where both spouses are earning. I have extended this principle to all married couples and legislation in the Finance Bill will be drafted on this basis for 1980/81 onwards. I await the decision of the Supreme Court in regard to the issues recently opened before it to determine the further measures, if any, I might be required to adopt.

### Home improvements

Last year a scheme was introduced, to operate for 1979/80 only, to give income tax relief, within certain limits, for the labour content of expenditure on home maintenance and improvements. As the implementation of this scheme was affected by last year's postal dispute, I propose to continue the relief for another year.

### Life insurance

I have received representations that the £1,000 limit on relief in respect of life insurance premiums, which was introduced in 1974, should be raised. Due to the restriction to one-sixth of total income on the amount of premiums qualifying for relief, an increase in the limit would only benefit persons with incomes over £6,000, who are already getting substantial tax relief under my Budget proposals otherwise. However, I have decided that where a husband and wife are assessed as single persons the £1,000 limit should be applied to premiums paid by each spouse on policies on the life of either spouse. Where a couple opt for income-splitting a limit of £2,000 will apply. This will cost £0.2 million in 1980.

### Compensation for loss of job

Representations have been made to me that the existing tax exemption limit of £3,000 in respect of lump sums paid as compensation for loss of employment is too low as it has not been changed since 1964. I propose to increase the limit to £6,000.

## FARMING

Developments in agriculture have generally been very favourable to our farmers since we joined the EEC. Last year was, however, an exception. Between 1975 and 1978 farm incomes rose by 76 percent but in 1979 it is estimated that they fell by about 4 percent. Proposals made recently by the EEC Commission on price fixing as part of the annual review of prices and on measures to deal with surplus production would, if approved, seriously affect our farmers, particularly those engaged in the production of milk and sugar-beet. These proposals would also seriously affect workers in the related food processing industries. The Government have already made known their opposition to the proposals and they will continue to oppose them strenuously.

A strong and developing agricultural sector is basic to the economic well-being of the nation. Agriculture supports not only those directly engaged in farming but also the many thousands of others working in food processing and in services. The rapid development of agriculture since we joined the EEC reflects the energy and dynamism with which our farmers have taken advantage of the opportunities opened to them through higher prices and free access to markets provided by the Common Agricultural Policy. Investment in land improvement and in up-to-date equipment and buildings has grown enormously — traditional methods are more and more giving way to modern sophisticated techniques of farm management and production.

There is a growing realisation of the mutual interdependence between the rural and urban communities. I am anxious that understanding between farmers and workers in general be promoted and fostered. I am heartened by the recent meeting between the farming organisations and the Irish Congress of Trade Unions to develop such understanding and also by the support given by the unions to the recent rally against the proposed super-levy on milk.

### Do farmers pay too little?

However, the proportion of tax paid by each sector has been unfortunately, a source of division rather than understanding between them. Since the introduction of farm taxation in 1974, taxpayers generally have felt that the amount of tax paid by farmers was less than was justified by reference to farm incomes and was not conducive to achieving equity between farmers and other sectors of the community. It is true that, in that period, farm incomes have risen substantially and the Government last year, after lengthy consultations, announced a revised system of farm taxation to be introduced this year.

Whatever differences of opinion exist on the appropriate relative share of tax paid by each sector, I believe there is universal acceptance of the principle that the amount of tax paid should reflect the income of the taxpayer. Where there is a decline in income as was experienced by the farming community in the unfavourable conditions of last year, the estimate of yield from tax must be reduced. To do otherwise would be to add a disproportionate burden of tax to the loss of income already sustained.

I do not therefore propose to insist that the yield from farm taxation in 1980 be of the same order of £100 million as was calculated before this fall in income emerged. I am not insisting on a pre-determined yield from the scheme that has been announced but I must estimate the likely yield from that scheme as with every other revenue category.

Deputies will be familiar with the scheme announced last year. However, I feel I should outline it here again, particularly as I propose to make some adjustments to it. These adjustments should have little or no revenue implications but should facilitate the operation of the scheme and at the same time take account of the special circumstances of the farming community.

In the first instance, the threshold for liability to income tax will be lowered from £50 RV to £40 RV, making a further 9,000 full-time farmers, or 36,000 in all, liable to income tax. However, marginal relief will apply between £40 RV and £49 RV, so that a farmer with a holding of £40 RV will pay only one-tenth of his full liability, two-tenths at £41 RV and so on until the full liability becomes payable at £49 RV.

All farmers who are liable to income tax will be assessed on the basis of their profits as shown in accounts. I recognise, however, that farmers between £40 and £50 RV entering the tax system for the first time may have difficulty in preparing accounts. Accordingly I have decided that a simplified form of accounts should be used in these cases. The Revenue Commissioners, at my request, are consulting with the farming organisations to examine the form such simplified accounts should take. A new mobile advisory service which I propose to provide for taxpayers generally, and to which I will refer later, should be of special assistance for farmers in this new category.

As is normal when the income tax threshold is lowered, farmers entering the tax net for the first time will have the option of presenting current year's accounts rather than the normal previous year's accounts. This option will only apply this year as the Government have decided that the tax threshold for farmers will not be further lowered within the next three years. I think this is desirable to enable the Government to assess the operation of the scheme as it now stands. It will also enable farmers to plan ahead without the uncertainty in this area which can sometimes appear to act as a disincentive.

## Lump sum assessment abolished

The notional basis of assessment will be abolished. The notional basis was introduced in 1974 and was designed to assist farmers who were not used to keeping accounts and in general to ease farmers into the tax system. It has now outlived its usefulness and can no longer be justified on equity grounds since it allows some of the highest-earning farmers to pay tax on only a fraction of their real incomes.

As announced, a restriction of capital allowances to 30 percent of net profit before deduction of capital allowances was to apply where accelerated allowances are claimed. However, as I am anxious to encourage investment for further development and increased productivity, I have decided that the restriction should be confined to plant and machinery only. This means that the restriction will not apply to farm buildings or to farm works such as land reclamation or fencing.

Over investment in plant and machinery inspired by tax avoidance is not in farmers' own best interest; nor is it in the best interest of the community as a whole since the bulk of farm machinery has to be imported to the detriment of our balance of payments. In addition, there is not a limitless pool of available credit for agriculture and wastefully soaking up an undue amount on plant and machinery which is not sufficiently employed to pay its way, deprives other more deserving and productive areas of the necessary funds. The restriction which will not affect ordinary wear and tear allowances, represents merely a deferment to later years of part of the extra capital allowances. It should not affect genuine investment which is so important to the development of agriculture.

## Rates on land

As regards rates on land, which was another element of the scheme, the Minister for Environment has already announced that he will shortly introduce the necessary legislation to lower the cut-off point for rates relief under the Agricultural Grant from £60 RV to £40 RV. The cut-off point will remain at £40 RV for three years.

The scheme announced last year provided that full-time farmers would no longer pay their income tax in a single payment on January 1st, but rather in two instalments on September 1st and January 1st, in the same way as other Schedule D taxpayers. I have already announced that a single payment date of October 1st is to be introduced this year for Schedule D taxpayers generally. However, if this were applied to full-time farmers, it would mean that they would pay two years' tax in 1980 — their full 1979/80 tax under the existing single-payment date system on January 1st last, and their full 1980/81 tax under the new single-payment date for Schedule D taxpayers on October 1st. I have decided to avoid this in the interest of equity in their case. I intend instead to postpone the payment of the first instalment of 1980/81 income tax to October 1st to coincide with the single payment date of other Schedule D taxpayers.

The resource tax on all holdings of £70 RV and over at a rate of £3.50 per £ RV will be introduced from April 6th 1980. It had been intended that this tax would have been payable in one instalment on September 1st. But, in line with what I have already indicated in relation to income tax, I propose that this date should be October 1st. Marginal relief will apply to holdings between £70 TV and £79 RV.

As I have indicated, I must provide in my Budget, as in all other cases, for an estimate of the revenue yield from the farm tax scheme. Accordingly the estimated 1980 yield will now be £86 million, consisting of £33 million from income tax, £46 million from rates on land and £7 million from the resource tax. This compares with £16 million from income tax and £36 million from rates on land in 1979.

The income tax reliefs which I have announced earlier will, of course, apply also to farmers.

This scheme of farm taxation is designed to move towards equity between taxpayers and indeed between farmers. I think that farmers themselves will recognise that it is in the interest of the farming community generally that farmers with sufficiently high incomes actually pay — and be seen to be paying — their fair share of tax from the income which they have. As I indicated to the farming organisations in my consultations with them, the operation of this revised scheme now being introduced will be kept under review in the interest of equity and in the light of experience of its operation.

### Gifts and inheritances

I have received numerous representations on the question of the liability of farmers to capital acquisitions tax, i.e. gift tax and inheritance tax, on the transfer of the family farm. Many farmers have been concerned about their possible liability to the tax in view of the big increase in land prices since the tax was introduced in 1976. Because of this land price rise the market value of many farms has in recent times been substantially higher than their income-earning capacity.

Despite a tendency lately for market prices to reduce more in line with use value and thereby easing this concern I have decided to increase the upper limit of the special agricultural relief from £100,000 to £150,000 in the Finance Bill, with effect from April 1st next. This will mean that the market value of agricultural property for the purposes of the tax may be reduced by up to £150,000 for farmer beneficiaries, thereby directly relieving the problem caused by the land price rise. The cost in the current year of this change will not be significant because of the time lag between liability and payment. I firmly hope that this concession will act as a real incentive to transfers of farms to the younger generation of the farming community, and thereby promote productivity and increase the income from family farms — to the benefit of the whole economy.

## ADVISORY OFFICE

It has been my experience and, I am sure, that of many Deputies that many taxpayers are bewildered about tax and find it difficult to come to grips with the complexity of the workings of the tax system. This may cause unnecessary apprehension which, in my opinion, can be overcome if the taxpayer could have access to an advisory service. Some people may not be aware that such a service is already provided in tax offices and is widely availed of. I have now arranged, in addition for the acquisition by the Revenue Commissioners of a mobile tax advisory office. This unit should be ready in a few months and will provide an advisory service for those not resident near tax offices. I stress that this service will be purely for advisory work, to enable individual taxpayers who need it to have direct access to advice, free of charge.

I will keep the operation of this service under review in the light of experience, to ensure that it is of maximum benefit to those taxpayers who require it.

Deputies will appreciate that its success will depend on the closest co-operation and understanding between the people who have access to it and the Revenue officers who are always ready to provide guidance for the public in filling in their returns form.

## BUSINESS

### Inventory

Stock relief was introduced as a temporary measure in 1975 in order to assist firms in certain sectors in coping with the effects of inflation on the cost of replacing stocks. Under present legislation, stock relief is available in respect of accounting periods ending before 6 April 1979. The 1979 Budget continued the relief for a further year at a rate of three-quarters of that previously allowed. I have decided that the relief should be continued for a further year at the level obtaining in 1979. This will cost the Exchequer £3 million in 1980.

### Manufacturers

The 1977 Budget introduced an incentive scheme whereby manufacturers showing certain improvements in output and employment could benefit from a special 25 percent rate of corporation tax. The scheme, whose terms were made more favourable in 1978, covered the years 1977, 1978 and 1979.

I have decided to extend the scheme to 1980 pending the introduction of the new 10 percent rate for manufacturing profits generally. As Deputies are aware, a 10 percent rate of corporation tax will come into operation as from 1 January 1981 and will run to the end of the year 2000. Provision will be included in the forthcoming Finance Bill to give effect to this scheme.

### Entertainment

Considerable disquiet has been caused by the fact that many business concerns are seen to entertain on an unduly lavish scale, ostensibly for the purpose of building up the goodwill required to secure and retain customers. The stricter test for determining the admissibility of expenditure incurred for business entertainment which was introduced in 1973 does not appear to be having the desired effects. Unnecessary entertainment not only entails a subsidy from the taxpayer but also arouses a sense of inequity in the minds of those taxpayers who cannot afford to indulge in it themselves. Accordingly I propose to limit the allowance for business entertainment expenses for tax purposes to 50 percent in future.

### Financial institutions

I am conscious of the vital role which the financial institutions play in providing for the requirements of industry and commerce as well as individuals. The question nevertheless arises as to whether the contribution to taxation by these institutions is fair and equitable having regard to the contribution being made by individuals to income taxation.

Intricate problems and interests other than those of the financial institutions themselves are involved and I am at present reviewing the matter. At the same time, I feel that this whole field might well benefit from the type of close and objective study which could be given to it by the proposed Commission on Taxation. I will consider, therefore, asking the commission, as soon as it is set up, to carry out such an investigation as a matter of urgency and, if practicable, to deal with the question by way of an interim report.

I have considered, as a general matter of tax equity, the desirability of bringing forward the time of payment of tax by companies in the light of the change now proposed in relation to individual taxpayers other than PAYE taxpayers.

This could be justified in equity, but I am also conscious of the effect which such measures could have on liquidity and investment in present circumstances. While keeping the matter under review, I have decided to defer making such a change for the present. I have also in mind that it would be useful if the proposed taxation commission were to investigate the contribution to taxation by companies at large and I would propose to ask them to include it in their programme of work.

## INDIRECT TAXATION

There is of course no escaping the fact that the income tax improvements and social welfare improvements being announced today must be met from taxation and the only realistic source for the vast bulk of this is indirect taxation. There is no scope through other forms of income taxation or of direct taxation otherwise for raising the amounts involved.

Pursuing the general social orientation of my proposals, I have concentrated my indirect tax proposals on discretionary expenditure as far as possible. In this way, the impact will be minimised on the necessities of life, and therefore on households and individuals whose means and commitments are such as to allow of only limited discretionary expenditure.

There are of course limits to the extent to which the wide range of essential public services can be financed from highly selective taxation, but my purpose has been to travel this road as far as I can.

The one area where I have felt obliged to tax less discretionary expenditure has been oil products and related headings. Energy considerations, balance of payments considerations, and of course revenue considerations all arise here. The balance of payments and budgetary needs I have already explained. We simply have to reduce our dependence on highly priced imported oils. Our pattern of usage of private motor transport in particular derives from an era when our roads and streets were less congested and when the human, environmental and financial costs of our habits were of little consequence.

It is vitally important for economic, social and environmental reasons that we rationalise our consumption habits. Car-pooling, use of public transport, good driving habits and staggered arrangements for delivery of goods to congested urban and city areas can all play a major role in relieving the obvious problems and ensure that motor transport can once again be an unqualified social and economic benefit for all. Some recovery of the lost ground of latter years in petrol taxation is clearly called for, together with a greater balance in taxation of oil products generally.

### Hydrocarbon oils

Excise on all of the hydrocarbon oils has not been increased since 1976, and road diesel has remained at its present level since 1969. I purpose the following increases.

First, I propose an increase of 20p per gallon for petrol, road diesel and liquid petroleum gas (LPG) used in motor vehicles. Revenue considerations demand that no undue encouragement be given to switching away from the more highly taxed petrol.

The rebate for diesel oil used in buses on services scheduled in accordance with the relevant legislation will be increased appropriately so that bus fares will not be affected.

I am particularly concerned about the special case of handicapped drivers, a concern which I believe the public share.

In order to avoid imposing additional taxation on these drivers, I am arranging that the rebate to them will be increased by the full amount of the duty. In addition, I am increasing from 450 to 600 gallons the annual quota allowed to these drivers.

### Other oils

I have given very careful consideration to the effects an increase in the duty on "other oils" might have on different categories of users, to energy conservation and to the alternative tax measures which might be otherwise required. I have decided that it would be appropriate, taking all the relevant factors into account, as they affect both individuals and industrial concerns, to propose an increase of 5p per gallon on these oils. By way of extension of an existing concession, producers with glasshouses of a minimum area of one quarter of an acre and mushroom growers with not less than 3,000 square feet of cultivation area will be rebated 3p of this 5p increase.

The additional revenue in 1980 from the tax increases on hydrocarbon oils is estimated at £113 million.

### Private motor vehicles

In the light of what I have already

said, additional taxation on private motor vehicles also clearly falls to be considered. I propose that the excise duty on private motor vehicles, including motor cycles, should be increased from 35 percent to 40 percent. This can be expected to result in an increase of about 3.5 percent in the retail price. The estimated revenue yield in 1980 is £9.2 million.

The total yield in 1980 from the foregoing proposals for tax increases would be £122.2 million. This would be far short of what is required to finance the cost of the reliefs in direct taxation so I must turn at this point to what are popularly known as the "old reliables". In doing so I am encouraged by the fact that these are discretionary expenditures, and expenditures not without their social undertones in some cases.

### Tobacco

I am proposing a tax increase of 10p in the retail price of the packet of 20 cigarettes in the most popular price category, with pro rata increases for cigars and other tobacco products. These increases are estimated to bring in extra revenue of £19.0 million in 1980.

### Spirits

An additional 16p tax is proposed in the retail price of a glass of spirits. This will mean an extra 8p on the normal half-glass measure. This is estimated to bring in extra revenue of £14.0 million in 1980.

### Beer

An increase of 6p is proposed in the tax element in the retail price of the pint of beer. This is estimated to bring in extra revenue of £30.8 million in 1980.

I also propose to increase the taxes on wine, cider and perry, and table waters.

### Wines

An increase of 40p is proposed in the tax element in the retail price of a bottle of table wine. The increase will be pro rata for stronger wines, and for sparkling wines the proposed increase is 80p per bottle.

### Cider

Following the restructuring of the excise duty on cider and perry in the 1979 Budget, I propose a modest increase of 10p in the tax element of the retail price of the gallon of ordinary cider. The change represents an increase of roughly 2.0p in the price of the ordinary flagon of cider. The highest strength will bear excise duty at the new rate proposed for "made wine", while cider and perry of intermediate strength will be increased by 55p a gallon.

### Table waters

The existing rate of excise duty of 10p per gallon on table waters has not been altered since 1975. I propose to increase the tax element in the retail price per gallon by 30p. The new rate will be equivalent to: 6.6p on the family sized bottle (1 litre), 2.2p on the 12 oz. can and 0.7p on the 4 oz. mixer.

I am very aware of the effects this increase could have on the smaller manufacturers of mineral waters so I propose to increase the existing rebate provision pro rata. The new level of rebate will be: 12.4p on the first 20,000 gallons of output and 6.2p on the next 80,000 gallons of output.
The increases proposed for tobacco, alcoholic drinks and table waters are estimated to bring in extra revenue totalling £75.8 million in 1980.

### Value-added tax

I consider in the special circumstances of this year and particularly from a balance of payments point of view that some more general constraint on expenditure is needed. The Government gave careful consideration to the question of some fundamental alterations in value-added tax. They decided, for reasons of social concern, that the present zero and 10 percent categories should remain unaltered but that an increase in the 20 percent rate to 25 percent would be justified and least likely to cause hardship. This will take effect from 1 May 1980. The additional revenue expected in 1980 from this change is £17.75 million.

I turn now to other, less general, excise and other duties where an upward adjustment of tax is necessary and appropriate.

### Televisions and records

It is proposed that the specific duty of £69 on the top category of colour TV sets will be increased by £10 with pro rata increases for all other categories of colour and monochrome sets. It is also intended to increase the excise duty on gramophone records from 30 percent to 40 percent.

### Cigarette lighters

I am aware that for some time now there has been a rapid growth in the sale of disposable cigarette lighters. Lighters are not subject to excise duty while matches are. Notwithstanding the fact that lighters attract VAT at a higher rate, the overall taxation favours lighters. For this reason I propose that a new excise duty of 20p per lighter be imposed on all lighters.

### Stamp duty on cheques

I propose to increase in the Finance Bill the stamp duty on cheques from 1p to 3p. The 1p rate has applied since February 1971.
These three changes will yield an extra £1.6 million in 1980.

### Minor excise duties

There is a large number of miscellaneous licences issued which bear an excise duty. They relate mainly to the alcoholic drinks industry and to auctioneering, betting and gaming, as well as to many other activities. I am having these examined with a view to increasing the duty, where appropriate, in order to bring them up to a realistic level in present day terms or, at least, to cover the present day costs of administering them. I would intend to make the bulk of these changes in the forthcoming Finance Bill.

I have already decided to increase the licence duty on gaming machines. The proposed new rate is £100 for a full licence for each machine and £25 for a quarter year. I am increasing the reduced rate licence to £16.50 a quarter, but at the same time extending it to cover Saturdays as well as Sundays and public holidays. I also intend to provide in the Finance Bill for an increase in the licence duty for gaming premises from £100 to £200.

I also propose to double the existing rates for firearm certificates. The new rate, for example, for a shotgun will now be £6.50 a year.

The additional revenue in this area of miscellaneous licence duties is estimated at £1.2 million in 1980.

I turn to two further revenue proposals, one affecting outdoor and the other indoor recreation. I feel I voice a commonly held view when I say that racecourse betting and dancing might be called on to make a contribution to revenue needs.

#### On-course betting

There is a wide differential between the 20 percent excise duty which applies to off-course betting and the 6 percent levy which operates for on-course betting with bookmakers. I am having the general role of the latter levy in the financing of the racing industry reviewed but, in the meantime, I propose to impose a stamp duty of 1.5 percent on on-course betting with bookmakers, the proceeds to accrue to the Exchequer rather than to the racing industry as in the case of the levy. The benefit to the Exchequer in 1980 is estimated at £0.5 million. Betting on the tote will be unaffected by this change.

#### Dances

Dances, discos, cabarets, dinner-dances and the like comprise one area which can bear an additional element of taxation. I am considering the various alternatives which may be open to me in this respect and I would intend to bring forward firm proposals at an early date.

Before I leave the area of excises, there are two subsidiary matters I would like to mention.

#### Small brewers

The first is the small brewers scheme which, by way of concession, I am continuing for a further year at a cost of £160,000 in 1980. The scheme, introduced in the 1978 Budget, readjusts the incidence of excise duty on beer so that the smaller producers bear a somewhat lesser rate of duty while the larger producers pay somewhat more.

#### Deferment of spirit duty

The second matter concerns the way manufacturers of spirits pay excise duty. The duty is paid at the end of the month following that in which spirits are released from bond, except for the month of March when the payment may not be deferred. This catch-up arrangement is a hangover from the old April to March financial year. I propose to replace it with a similar arrangement which would operate in December.

This has the once-off advantage from the budgetary point of view of bringing forward to this year the duty which would have been deferred to end-January, 1981. The gain to the Exchequer in 1980 is estimated at £8.3 million.

#### Motor vehicle duties

My next proposals concern motor vehicle duties and relate back, to some extent, to the duty increases on petrol and oils; they have both conservation and revenue implications. I propose an increase in the initial and annual registration charges for cars of 16 horse power and under from £5 to £10; an increase in the charges for motor cycles from £1 to £5; an increase in the annual charge on excavators, agricultural tractors and other agricultural vehicles to £10; an increase in the driving licence fee from £2 per annum to £3 per annum.

The new rates will apply from April 1st, 1980. The extra yield in 1980 from these changes will be about £3.5 million.

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### TAX EVASION

I have mentioned the matter of abuse of the social services. This brings me to the even graver matter of abuse of the tax system in various forms.

The changes I have made in the income tax structure represent a major effort to make it a just and equitable system. It is no less important that the system should be seen to be enforced fairly and equitably. The vast majority of citizens co-operate in a public spirited manner in paying their taxes but there is unfortunately a minority in the community who do not act in this way. By evading payment of taxes they pass on their share of the burden to their fellow citizen who in many cases may be less well-off and less well able to pay tax. The taxes payable by our community are imposed in the name of the community and are expended on purposes determined by the community in a democratic process. Evasion of those taxes cannot be condoned by specious argument.

The tax evader, insofar as he engages in deliberate infringement of the law through fraud, misrepresentation and false declarations, can expect the full rigour of the law to be applied against him. I wish to reassure taxpayers that in all such cases prosecutions will be brought by the Revenue Commissioners instead of their seeking discreet settlements. Over the past few years, there has been a significant increase in the number of cases where proceedings were initiated.

While a person engaged in tax avoidance may feel he is operating within the law, the margin between avoidance and evasion in many cases is no more than hairline. I would like it to be understood by those engaged in schemes of tax avoidance, particularly schemes which have no real economic or commercial justification, that the operation of such schemes will not be immune from changes in the law.

There are people who are avoiding paying taxes because their business activity has not come to the notice of the Revenue Commissioners. Last year the provision of additional staff enabled the Revenue Commissioners to set up special inquiry units with an emphasis on outdoor investigation, to uncover traders and landlords and providers of services and others whose business is not on record for tax purposes or whose scale of business is not fully reflected in tax returns. In recent months 6,150 such cases have been uncovered.

There is an onus on all persons engaged in business to complete tax returns. If they do not, they must realise that when discovered, the transactions of previous years will be reopened and arrears of taxes, together with any appropriate interest and penalties, will be fully recovered from them.

Very considerable changes have been made in recent years in the legal powers of the Revenue Commissioners to deal with tax evasion and omission to provide information. These powers are now being used by the Revenue Commissioners to protect the interests of the vast bulk of the community who are paying their share of taxation and, if it seems necessary to strengthen the law further, I will have no hesitation in putting forward new proposals for legislation.

If every wage earner has his tax calculated precisely on his income and deducted at source, surely justice and equity require that the self-employed and professional classes should also disclose their income fully and pay their tax accordingly. As Minister for Finance, I feel an obligation to secure that all taxpayers receive the same treatment and I will make available to the Revenue Commissioners all necessary resources to implement this principle.

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See for an analysis of the Irish Budget 1980 the articles which are published in 20 EUROPEAN TAXATION (1980):

Norman E. Judge: *Ireland: Changes in personal taxation* (p. 76).

C. Salomons: *Ireland: An urban budget* (p. 82).

# ZAMBIA: Budget Speech 1980

Extracts from the Budget Speech pronounced on January 25, 1980 by the Hon. K.S.K. Musokotwane M.P., Minister of Finance.

## REVENUE MEASURES

127. Mr. Speaker, Sir, I have already referred to the size of the Budget. I have pointed out that total expenditure (including lending) will be K1,030 million, and that recurrent revenue available will be K758 million, leaving an overall deficit of K272 million. Mr. Speaker, Sir, I have already explained the financing of this deficit.

128. Sir, included in the recurrent revenue figure of K758 million is a sum of K27 million which I hope to raise through new measures. Let me now turn to the discussion of these measures.

129. Mr. Speaker, Sir, the measures I am introducing are aimed specifically at mobilising additional revenue. But some of these are introduced with the objective of discouraging consumption of luxury items and more importantly the promotion of conservation of expensive imported materials. This is primarily intended to help in strengthening our balance of payments position, a policy objective I outlined a little while ago.

### (a) Excise duty

130. Mr. Speaker, Sir, I wish to commence with an outline of the measures under the category of excise duties. As Hon. Members are aware, the offtake from this source of revenue is a direct function of the volume of production or sales of goods. Government revenue thus does not change with any price increase decided on by a manufacturer. It is therefore necessary to protect our revenue offtake from inflation.

*(i) Clear beer*

131. Mr. Speaker, Sir, the demand of beer in Zambia continues to be relatively high. In some parts of the country the constraint seems to be insufficient supply which in many instances reflects production and distribution problems. I am therefore proposing that the price of beer should be raised by 5 ngwee per bottle. The manufacturers will receive I ngwee of this increase. Furthermore the retailers will receive 2 ngwee of the increase. This will improve the retailers' margin to the extent where it should be profitable to distribute beer to all parts of the country. Finally, 2 ngwee will accrue to the Government. I hope to raise K4.9 million in additional revenue from this measure which will take effect from midnight tonight.

*(ii) Opaque beer*

132. In the same vein, Mr. Speaker, Sir, there is need to adjust the price of opaque beer. I therefore propose an increase of 1 ngwee per litre with effect from 2400 hours tonight. This measure will yield K2.6 million in additional Government revenue.

*(iii) Cigarettes*

133. Mr. Speaker, Sir, Hon. Members will agree with me that the prices of cigarettes are still comparatively low in this country. As long as production is maintained at reasonable levels, this is a valuable source of revenue for the Government. I propose that the prices of cigarettes be increased by between 10 percent and 17 percent, with the largest percentage increase for the top luxury grades. This will mean an increase of 10 ngwee per packet of 20 cigarettes for the most expensive brands, 6 ngwee for the middle priced brands and 4 ngwee for the lowest priced brands. This measure will yield an additional K4.8 million in Government revenue and comes into effect from midnight tonight.

*(iv) Soft drinks*

134. Mr. Speaker, Sir, there is a general consensus in this country that the prices of various types of soft drinks are still very low. In fact some soft drinks are still cheaper than in the countries from where some of the ingredients are imported. Indeed, soft drinks are more commonly consumed by urban dwellers. I have decided, therefore, to propose an increase of 4 ngwee per 290 millilitre bottle. Out of this increase the manufacturers will get 0.5 ngwee, the retailers 0.5 ngwee and the Government will receive 3 ngwee. This measure will yield an additional K3.5 million in Government revenue and takes effect from midnight tonight.

*(v) Petrol and diesel*

135. Mr. Speaker, Sir, this House must now be conversant with the turbulent situation prevailing in the world oil market. Earlier this afternoon, I informed this House that the oil market is now extremely volatile with a multi-varied pricing system where availability and security of supply are the overriding considerations. I would like, Mr. Speaker, Sir, to inform Hon. Members that we as a nation will this year spend K130 million in foreign exchange on oil imports. It is imperative that we, like many other non-oil producing countries, take measures to reduce the wasteful consumption of expensive petroleum products. Since the price mechanism is one way of reducing consumption. I am proposing that the prices of various grades of petrol be adjusted upwards as follows:

Petrol — super grade to go up by 2 ngwee per litre;

Petrol — regular grade to go up by 2 ngwee per litre.

136. I also submit here that contrary to popular belief, diesel is not a cheap fuel at source. It is an expensive item commanding the same price as other fuels. To make matters worse diesel has become such a scarce commodity that suppliers may cut back on the amount they supply in our imported crude feedstock. In this situation we must take measures to prevent wasteful use. I am therefore proposing that the price of diesel should be raised by 2 ngwee per litre. As usual, the necessary tax concession has been given to the United Bus Company of Zambia (UBZ) so that its users will not face any hardship.

137. Mr. Speaker, Sir, I estimate that these measures will bring an additional K7.7 million in Government revenue and will take effect from 2400 hours tonight.

### (b) Customs duty

138. Mr. Speaker, Sir, Hon. Members will recall that the rate of customs duty on capital goods was last adjusted upwards in 1978. This adjustment was from 5 percent to 7.5 percent on a specified list of items. The measure was intended to promote more labour intensive methods of production. Hon. Members will also agree with me that Zambia is one of the few countries in the world where capital goods are virtually free of duty. We must continue to encourage more use of our labour in keeping with our policy of creating more employment opportunities, a policy to which I referred earlier this afternoon.

139. I have therefore decided to adjust upwards the rate of customs duty on a selected number of capital items from 7.5 percent to 10 percent. I hope that this will further strengthen our resolve to discourage labour-saving machines. Sir,

I have also decided to suspend the import duty on sports goods like football, hockey, cricket and other outdoor games, but excluding equipment for hunting, shooting and fishing. This is in response to the resolution of the National Council and to persistent requests and representations on the matter.

140. Sir, there are also a number of minor proposals meant to tidy up the Customs and Excise Act. Included in this exercise are adjustments in the rates of customs duty on imported items competing with locally produced goods on which excise duty has been adjusted upwards. Such increase in customs duties are meant as a countervailing measure to discourage unnecessary imports.

141. Mr. Speaker, Sir, I estimate that the measures on customs duty will yield an additional K1.7 million in Government revenue and will take effect from midnight tonight.

142. Mr. Speaker, Sir, I have proposed a small increase in the price of diesel. This will affect the agriculture industry. Many of our farmers are now using diesel in increasing amounts. As such they need some relief. Indeed farmers also need added incentives to increase their production. I am therefore proposing to amend the relevant regulations of the Customs and Excise Act to enable the Minister of Finance to give duty exemption on some imported agricultural equipment. This will be on a case by case basis and shall apply to deserving cases only. Sir, this is a very attractive incentive and I hope the response will be reflected by increased agricultural output next year.

### (c) Sales tax

143. Mr. Speaker, Sir, last year, my predecessor reduced the rates of Sales Tax on a number of essential household items. I do not propose to make any adjustments to these. However, in order to raise revenue, I am proposing to raise the rates on a number of items as follows:

Sugar confectionery — from 10 percent to 15 percent
Paints, varnishes and lacquers — from 10 percent to 15 percent
Gramophone records — from 10 percent to 15 percent
Tarpaulins, tents, awnings, etc. — from 10 percent to 15 percent

144. In addition, I propose to extend the coverage of Sales Tax to aerosols, insecticides and metal holloware. The rate of Sales Tax on these items will be 10 percent.

145. Mr. Speaker, Sir, I expect these measures to yield about K1.8 million in additional Government revenue and will take effect from midnight tonight.

### (d) Passenger service charges (International)

146. Mr. Speaker, Sir, Hon. Members are aware that the cost of running our airports is considerable and increasing. This House will recall that in order to assist in the proper maintenance of airports, the Government introduced a passenger services charge which is paid by passengers departing for destinations outside Zambia. This was first introduced in 1972 and was increased from K3 to K4 in 1978. In order to offset the effects of inflation on the value of revenue from this source, I propose that with effect from 1st April, 1980, all passengers on international flights departing from our airports for destinations abroad should pay a service charge of K8.00. This measure is expected to add K200,000 to Government revenue.

### (e) Income tax

147. Mr. Speaker, Sir, I wish to inform this House that my Ministry has received numerous representations on income taxes from a cross-section of the population in this country. Some representations merit close attention. Others obviously are mere compliants.

148. Earlier this afternoon, in my discussion of industrial and investment policy, I informed this House that the overall strategy of the Government is one of consolidation and clarification of existing incentives to investors and manufacturers. In view of the need to encourage investment, I have given considerable thought to all the submissions by our business community. Hon. Members will agree with me that if the Government were to accede to all the requests, the loss in revenue would be staggering. However, I have made some concessions which I hope will go some way in meeting the wishes of our business community.

149. Firstly, I have decided, under capital allowances, to raise the maximum amount allowable as a deduction for the cost of a road vehicle used for business purposes from K4,000 to K6,000. This increase has become necessary in view of the rising prices of motor vehicles. This means that the ceiling on allowances for purposes of wear and tear will be much higher taking into account the effects of inflation. This comes into effect on 1st April, 1980.

150. Secondly, and in the same vein, I have decided to raise the ceiling amount allowed for purposes of initial wear and tear on low cost houses. The ceiling will rise from K4,000 to K10,000. This is an attractive concession which businessmen should utilise and help to relieve pressure on local authorities for low cost housing. This concession will come into effect on 1st April, 1980.

151. Mr. Speaker, Sir, one of the areas in which there has been an outcry concerns Undistributed Profits Tax. Last year, the relevant section of the Income Tax Act which dealt with distributions of dividends was repealed and the Undistributed Profits Tax was introduced. Sir, I wish to inform the House that I have found it impossible to completely do away with the Undistributed Profits Tax as most of the business community would want. However, I feel that certain provisions of the law are too rigid. I have therefore decided, that in order to satisfy some of the demands of the business community and to introduce some flexibility, the Act will be amended to allow for business expansion requirements, i.e. reinvestments, reasonable reserve levels and other requirements to be taken into account before the Undistributed Profits Tax is applied.

152. Sir, I am satisfied that my proposal is equitable to the business community and to the Government. It remains for me to commend the business community for the very constructive manner in which they have put forward their representations and suggestions. I hope businessmen will take advantage of the new arrangements and expand their enterprises.

153. Last year, my predecessor introduced a job credit facility as an incentive to the manufacturing sector to create new jobs. Considering the fact that we also have the Industrial Development Act which extends tax incentives to all our economic sectors, I have found it necessary to rationalise this facility. Sir, instead of allowing a flat amount as credit, I have decided to tie the facility down to the salaries or wages payable to the qualifying employees. In the first charge year of the qualifying period in which an employer has commenced qualifying business, 10 percent of the basic wages or salaries payable in respect of all qualifying employees during such charge year, will apply. In subsequent charge years of the qualifying period, 5 percent of the basic wages or salaries payable will rank as a job credit against the manufacturer's tax. The facility will also be on a once and for all basis instead of being carried forward. I have decided to introduce this amendment in view of the potential loss of Government revenue due to the loopholes I am now removing from the facility. I believe this will be fair to the Government as well as the manufacturers intending to use the facility.

154. Mr. Speaker, Sir, there are also other minor amendments to the Income Tax Act which are merely part of the continuing exercise of tidying up our legislation in the light of new developments.

155. Finally, Mr. Speaker, Sir, Hon. Members will recall that earlier this afternoon I informed this House that the

Special Reconstruction Fund for the repair of bridges and other damaged installations now stands at just over K1 million from contributions by the people of this country. In a further expression of appreciation for this show of committment and patriotism, the Party and its Government have decided that all cash contributions to this Fund will be allowed in full for tax purposes. This will also apply to future cash contributions. Once again, I wish to publicly thank all those who have contributed so generously.

## CONCLUSION

156. Mr. Speaker, Sir, I have now come to a stage where I must conclude my remarks. Before I do this, allow me the opportunity to summarise what I consider the critical issues facing the Zambian economy. The paramount objective must be to ensure that the nation spends within the limits of available resources. This will mean limiting recurrent expenditure to the most essential areas. It will also entail capital spending based on national priorities that aim at increasing employment and productivity. In addition we must not relax in our resolve to restrain inflation. We must also jealously protect the industrial peace which this country has enjoyed for a long time now.

157. Hon. Members should have noted my call on all of us to temper our optimism with caution since a number of critical factors affecting our economy are beyond our control. Indeed the world situation is so uncertain that it is difficult to confidently predict future developments. We must therefore ensure that we prudently budget the use of scarce foreign exchange resources. This country has the natural resources and ability to uplift the well-being of its people. We have a duty to leave a better country for future generations. We can only succeed if we follow the correct policies and determine the correct priorities.

158. Mr. Speaker, Sir, we have been faced with problems as a nation since Independence. We have continued to overcome all these. These problems have made our national character ever stronger. Because of the difficulties we have gone through, we have been able to demonstrate and prove to ourselves and to the world that we are a strong and determined people. Let us therefore continue building for ourselves and for posterity a Zambia that is happy and prosperous.

159. Let us avoid servitude by continuing with individual and national self reliance and discipline. Let us use our past mistakes as lessons to learn from and our past successes as a foundation to grow from. Let us all work hard. Let us all work together. Let us remain united and concentrate on working out solutions to our problems. Let us realise that the greatest asset of Zambia is the people themselves. Let each one of us in the leadership rededicate ourselves to the unity of this nation. We have in His Excellency the President Dr. K. D. Kaunda a uniting factor. Let each one of us exploit this to the full.



# IRAN

# To pay or not to pay: that is the question

*It has been brought to our notice that the Revolutionary High Council of the Islamic Republic of Iran passed a law on 14.9.1358 (December 5, 1979) which facilitates the settlement of outstanding tax liabilities incurred during the Iranian year 1357 (March 21, 1978 to March 20, 1979). The major points of the law are subject to dispute but the first Article caught our eye. It must be one of the few, and maybe the only one, which leaves the discretion of the amount of tax to pay to the taxpayer. The gist of the Article is that taxpayers with a basic tax liability for that period of Rls.50,000 or less need pay only what they consider justified. They are protected from further recourse by the tax authorities as the Article goes on to say that the receipt obtained for this voluntary payment will be accepted as evidence of final settlement.*
*How much would you pay?*

# CONFERENCE DIARY

## JUNE 1980

*Business International Institute:* The Seminar on International Finance (including: Taxation of exchange gains and losses), Port Chester, New York (U.S.A.), June 9-12 (English).

*Georgetown University Law Center* and *The Chamber of Commerce of the United States:* Institute on multinational taxation (treaty problems anti-avoidance measures, use of computers in international taxation, currency gains and losses, international insurance transactions, Brazilian taxation), Washington D.C. (U.S.A.), June 11-13, 1980 (English).

*European Study Conferences Limited:* International tax planning conference; protection of assets of companies and trusts in the face of risk (including exchange of information between tax authorities), London (United Kingdom), June 12-13 (English).

*European Study Conferences Limited:* Investing in United States real estate in the light of the current and proposed financial and taxation considerations, Amsterdam (the Netherlands), June 19-20 (English).

*Institute for International Research:* Successful trading in commodities (including the tax angle — consider it before you trade!), London (United Kingdom), June 24-25 (English).

*Inter-American Center of Tax Administrators (CIAT):* Fundamental tax audit considerations (including: Components of an audit program, organization of a tax audit department, EDP and tax audit, resource management support, legal aspects of tax audit), Washington (U.S.A.), June 22-27 (English, Spanish).

## JULY 1980

*Management Centre Europe:* The China Briefing (including: Tax aspects of doing business in China), Brussels (Belgium), July 3-4 (English).

*Management Centre Europe:* Managing and developing foreign subsidiaries seminar (including: Tax in international operations), Brussels (Belgium), July 2-4 (English).

*Management Centre Europe:* International tax management seminar (including: Anti-tax haven legislation, tax treatment on technology import and technology export, handling of disputes between tax administrations), Brussels (Belgium), July 10-11 (English).

## AUGUST 1980

*Management Centre Europe:* International cash management seminar (including: International tax aspects in cash management), Brussels (Belgium), August 20-22 (English).

## SEPTEMBER 1980

*34th Annual Congress of I.F.A.:* I. The dialogue between the tax administration and taxpayer up to the filing of the tax return; II. The determination of the source of income. For the seminar the subject is the flight to tax havens, their use and abuse, Paris (France), September 14-19 (English, French, German, Spanish).

## NOVEMBER 1980

*Confédération Fiscale Européenne (C.F.E.):* Second congress of European tax consultants (subject: "La pratique de la fiscalité en Europe"), Rome (Italy), November 6 and 7 (English, French, German).

## SEPTEMBER 1981

*35th Annual Congress of I.F.A.:* I. Mutual agreement procedure and practice; II. Unilateral measures to prevent double taxation. Berlin (German Federal Republic), September 21-25 (English, French German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

Business International Institute, 12-14 chemin Rieu, 1211 Geneva 17 (Switzerland).

CIAT: P.O. Box 2129, Panamá 9A (Panama).

Confédération Fiscale Européenne, Secrétariat Général (C.F.E.), D-5300 Bonn 1, Dechenstrasse 14, German Federal Republic of Siège Social F-75009 Paris, 9 rue Richepanse (France).

European Study Conferences Limited, Kirby House, 31 High Street East, Uppingham, Rutland, Leics. LE 15 9 PY, United Kingdom.

Georgetown University Law Center, Office of Continuing Legal Education, 600 New Jersey Ave., N.W., Washington D.C. 20001 (U.S.A.).

Institute for International Research, 70 Warren Street, London, W1P 5PA (United Kingdom).

International Fiscal Association (I.F.A.): General Secretariat, Woudenstein, Burgemeester Oudlaan 50, P.O. Box 1738, 3000 DR Rotterdam (Netherlands).

Management Centre Europe, Avenue des Arts 4, B-1040 Brussels (Belgium).

# TAX GLOSSARY

*by H.W.T. PEPPER* *

**RETROGRESSION (RETRO-ACTION), RULE AGAINST** — It is a generally accepted principle of taxation that new tax laws, or Court decisions on cases brought before them, should not ordinarily seek to change the incidence of tax on transactions that had already taken place before the law was enacted or the Court decision handed down. There have been one or two exceptions to this rule in practice; for example, in Britain an income tax provision charging tax on GOLDEN HANDSHAKES (q.v.) was enacted as a part of one year's budgetary proposals after a warning had been given in the previous year that such action would be taken if the practice of making such transactions did not cease. The retrogressive effect in this particular case related only to transactions that had taken place following the warning given.

The latest development in the running battle between tax administrations and professional "avoiders" was the statement in a 1979 Budget Speech in the U.K. to the effect that any new tax avoidance schemes would be counteracted by law retrospectively.

**RETURNS** — Declarations of income, sales, and other details required by tax authorities, often on forms officially provided, which are to be "returned" to the authorities.

**REVALUATION OF (DEPRECIABLE) ASSETS** — An alternative to a system of REPLACEMENT-COST DEPRECIATION (q.v.), where inflation in a country has increased the replacement cost of assets considerably above historic cost, is to revalue the asset and then re-calculate depreciation allowances on the revised values. It is not usually administratively possible to calculate indices of revaluation for each of the many types of asset involved, so that in practice some established index of prices compared with a base year would normally be used even though the results may be anomalous between different industries.

**REVENUE ERROR** — See REMISSION ON REVENUE ERROR.

**REVENUE-SHARING** — A system introduced in the U.S.A. in 1974 whereby State and local governments were granted a share of certain Federal revenues for which, however, the Federal Government remained the collecting agent. The system is also known as PIGGY-BACKING. In Sweden, joint collection of national and local government income taxes has been in operation for many years, as has a system in the U.K. for joint collection of income tax and certain pension contributions — systems which are broadly similar to revenue "sharing".

**REVENUE TAXES** — Taxes which are levied to produce revenue rather than to serve any particular fiscal of economic purpose.

**RECOVERABLE SETTLEMENT** — Under U.K. tax law, settlements which transfer income to other persons, but which are subject to any form of revocation, are set aside for tax purposes by Sections 445 and 446 of the 1970 tax code, the income involved being regarded as the income of the settlor.

**RIBICOFF AMENDMENT** — See OVERSEAS EMPLOYMENT.

**"RING"** — In connection with a single stage sales tax where tax is payable only on sales to non-registered traders or consumers, the traders who are registered are said to form a "ring" in that purchases and sales among such traders (i.e. transactions within the "ring") are not taxable, but as soon as goods are disposed of outside the "ring", tax becomes payable.

**"RING FENCE"** — A term used in connection with PETROLEUM REVENUE TAX (q.v.). The profits of each field are dealt with separately — there is a "ring fence" placed around them in that external losses may not be offset, except in the case of a final loss in another terminating field.

**ROAD TAX** — It is common to levy various forms of taxation on vehicles using public roads, the justification being the cost of maintenance of the roads themselves, the main wear of which is caused by those using such vehicles. The tax may be based on the horsepower of a vehicle or the cubic capacity of its cylinders, or may be related to the laden weight of goods vehicles or the passenger-carrying capacity of buses and coaches. (See also ROAD TOLL.)

**ROAD TOLL** — During the era of turnpike roads in Britain, private entrepreneurs or land owners were authorised to build roads and charge tolls, the tolls being collected at turnpikes from those who used them. Because those entitled to collect the tolls tended to be more diligent about collecting them than maintaining the roads for which they were paid, the system fell into disrepute and was abolished. At the present time, however, a number of countries charge tolls on motor roads and bridges which are available for certain types of vehicle only, the roads and bridges, however, being provided and maintained by the government. Such charges are, for example, made in the U.S.A., Italy and France. The essential basis for such a tax must be that the road is used by a large volume of traffic, so that the cost of collection would only be a small fraction of the total tolls collected and that the payment process will not unduly slow down the flow of traffic. The term "turnpike' to denote a road on which tolls are charged is still used in the U.S.A.

**ROERENDE VOORHEFFING** — (Belgium) Advance payments (usually withholding tax) of tax on dividends, royalties and interest.

**ROLL-OVER RELIEF** — Relief from capital gains of income tax granted where assets of one class are disposed of and the proceeds of disposal are reinvested in replacement assets of the same class and where the profit on disposal would otherwise have been chargeable to tax. Such relief is provided, for example, in the U.K. (see Section 33 F.A. 1960 and Section 60 F.A. 1971). In Britain the relief is applied to business assets; in the U.S.A. it is also applied for capital gains tax purposes (in lieu of exemption) to private residences.

* With the assistance of the staff of the International Bureau of Fiscal Documentation.

**ROOM TAX** — A tax charged on the occupancy of rooms in a hotel, usually at a fixed rate per head per night, but sometimes on a graduated basis according to the price of the rooms. A room tax is thus a tax on hotels (and sometimes others providing accommodation for tourists at a fee) but the tax is not usually extended to the other services provided by the hotel, including the provision of meals in its dining rooms.

**ROYALTIES, COPYRIGHT** — The most important international flow of copyright royalties is usually that of sums paid for the hire or rental of cinematograph films. Other copyright royalties may be taxed by deduction at source, particularly where the royalties are payable to a non-resident, but double taxation treaties often mutually exempt such payments from taxation in the country of payment. (See FILM HIRE TAX, FOOTAGE TAX.)

**ROYALTIES, MINERAL** — See MINERAL ROYALTIES.

**ROYALTIES, PATENT** — As in the case of copyright royalties, tax is often deducted at source from payments of patent royalties made to non-residents (in Britain, from all such payments), subject to exemption which may be granted on a mutual basis in double taxation treaties, the country of residence taking full powers to tax.

**ROYALTIES WELFARE LEVY** — A levy originally concurrent with MINERAL RIGHTS DUTY (q.v.) in Britain imposed in 1910 on coal royalties and abolished when coal deposits were nationalised in 1946.

**RÜCKLAGE** — (Germany) Reserve for future contingencies.

**RÜCKSTELLUNG** — (Germany) Reserve for debts or losses existing at the balance sheet date, the amount of which is not precisely known.

**RUMMAGE** — The process of making a detailed search of a ship by Customs officials in a quest for contraband is known as "rummaging" the ship.

# S

**SAERBESKATNING** — (Denmark) Separate assessment.

**SAFETY EXPENDITURE** — Expenditure on fire prevention, accident prevention, and so on, usually is given favourable tax treatment: either the expenditure may be deducted when incurred, or the total cost may be written off over a period of years.

**SALE AND LEASE-BACK** — See LEASE-BACK.

**SALE OF INCOME** — The device of selling present or future earnings for a capital sum in order to avoid or reduce tax liability (see, per contra, SPREADING) is countered in some countries' tax codes (U.K., U.S.A.) by making the resulting lump sum taxable as income.

**SALES AND USE TAX** — The scope of sales taxation in a country with a federal government, where the individual states or provinces have the power to levy sales taxation, is often expanded to a charge on "sales and use". The "use" element deals with the case where residents of the taxing state purchase taxable goods outside the taxing state from other states within the same federal jurisdiction, sometimes from "inter-state" enterprises that operate in several different states within the country. The scope of the tax is thus extended to cover sales outside the state, but within the country as a whole, which are made to residents of, in respect of goods used in, the taxing state. The "use" provision counters tax avoidance and equalises the tax position of traders within the taxing state with traders outside who sell to residents of that state.

**SALES TAX** — An ad valorem tax on sales of goods, and sometimes services also, usually calculated at a percentage rate, and collected at regular intervals (e.g. monthly or quarterly) from traders who are entitled to "shift" the tax to their customers by suitably adjusting the prices of the goods or services the traders provide.

**SALES TAX LOTTERY** — See LOTTERIES FOR CONSUMERS.

**SALVAGE VALUE** — The residual value (which may be merely a scrap value) of depreciable assets at the end of their service life when capital or depreciation allowances are given in respect of the cost of providing the asset. The sale proceeds or salvage value of the asset when it is taken out of service are usually credited in computing the total deduction for depreciation (see BALANCING ALLOWANCES AND CHARGES). An estimate of the ultimate salvage value of an asset may be taken into account, along with estimated service life, when computing the appropriate depreciation allowances.

**SAMBESKATNING** — (Denmark) Joint assessment of combined incomes of husband and wife.

**SAMBESKATNING SELVANGIVELSE TIL** — (Denmark) To file a joint return.

**SAMTIDIGHEDSSKAT** — (Denmark) Pay As You Earn (P.A.Y.E.)

**SANDWICH EFFECT** — The term "sandwich effect", in connection with a V.A.T., is applied to the situation when an exempt trader buys taxed goods and sells them, after processing, to a taxable trader. In the absence of special provisions, no relief would be due to the trader who finally sells to the consumer in respect of the tax originally embodied in the goods when they were purchased by the exempt trader. In fact, relief in these circumstances has in some instances been allowed to the final trader, notably in Brazil's V.A.T. (I.C.M.), and another remedy is to allow the "sandwiched" trader who buys the taxed goods to have "zero tax" treatment so that he may re-claim the tax he paid on purchase. In the latter case the goods then pass free-of-tax to the next trader, who has to account for the total tax on his sales but at least has incurred no pre-payment of tax which cannot be requited. (See also ZERO RATE.)

**SATS (SKATTESATS)** — (Denmark) Tax rate.

**S.A.Y.E.** — Save-As-You-Earn, the name given to various schemes whereby employees and others may contribute regular sums by way of savings which are refundable after five or more years with the addition of interest and/or a bonus or premium. Such schemes have relevance for taxation only where, either, some tax deduction is allowed for the contributions made, e.g. by employees who authorise deductions from their pay for the purpose, or where the bonus or interest element in the amount realised at the termination of the deduction period (i.e. the excess of the sum paid out over the amounts contributed) is exempted from tax.

**SCHACHTELBETEILIGUNG** — Participation of at least 25 percent by a German company in the control of another German company.

**SCHACHTELVERGÜNSTIGUNG (also SCHACHTELBEFREIUNG or SCHACHTELPRIVILEG)** — Exemption from corporate income tax granted to German parent companies in respect of dividends from their German subsidiary companies.

**SCHEDULAR TAXATION** — Taxes on particular items of income which are applied as separate taxes, often at fixed rates, in contrast to the system of aggregating all income accruing to the same person and applying graduated rates thereto, which is the more usual form of income taxation at the present day. An example of a country which retains some elements of schedualr taxation in its income tax system is provided by Hong Kong.

**SCHEDULES A TO F** — Under the British income tax system tax is levied under different "schedules" or divisions according to the nature and source of the income. This compartmentalisation does not affect the incidence of the tax, which is a graduated charge upon total aggregated income. Income is classified under the various schedules, as follows:
*Schedule A:* Net profits from rents on leases of land, ground rents, feu-duties and other annual payments from land and other receipts arising from the ownership of, or rights over, real property.
*Schedule B:* Income from the occupation of certain woodlands if the occupier has not opted to be assessed under Schedule D.
*Schedule C:* Interest from certain securities of the British and certain overseas Governments where it is paid in Britain, the tax being paid by the paying authority and deducted from the interest paid to the investors.
*Schedule D:* Profits on trades, businesses, and professions, and woodlands where the owner has opted to be taxed on his commercial profits therefrom, and certain other income including interest on loans, rents and other income from real property, and certain income from abroad. This Schedule is subdivided into a number of "Cases" and the Short-Term Gains Tax (abolished April 1971) was formerly included in Case VII.
*Schedule E:* **Income from offices,**
*Schedule E:* Income from offices, employments or pensions. The schedule is subdivided into "Cases", according to the territorial source of the income.
*Schedule F:* Dividends and other distributions of resident companies.

**SCHENKINGSRECHT** — (Holland) Gift Tax.

**SCHENKUNGSTEUER** — (Germany) Gift Tax.

**SCHIJVENTARIEF** — (Holland) Tax rate computed on slices of income.

**SCISSION** — (France) Company splitting.

**SCISSORS TRANSACTIONS** — A tax avoidance device whereby a company trading in securities would buy (a controlling interest in) another company, arrange for its assets to be realised (or "stripped") then re-sell the company at a loss, deductible from its own trading profits.

**SCOPE OF TAX** — The "scope" of a tax, sometimes referred to as the "tax base", is its coverage, which includes the geographical area to which it is applied, the nature of the capital, income, or transactions which is to be taxed, and the persons, e.g. resident and non-resident individuals, corporate bodies and other bodies or artificial persons to whom, and in some cases the period of time (e.g. the duration of a war, emergency, or of inflation or depression) during which, the tax is to be applied.

**SCRIP DIVIDEND OPTION** — During the time that Governmental rules limiting dividend payments (an anti-inflation device) were in operation some companies offered shareholders an option to take scrip (stock) dividends instead of cash. Initially the move, which enhanced the anti-inflation effect of the Government's restrictions, was encouraged by the exemption of such dividends from income tax, though subsequent sale of the extra scrip would have entailed capital gains tax. After April 1975, however, such scrip dividends were made liable to income tax and options were thenceforward no longer offered.

**SCUTAGE** — A medieval levy in Britain under the Feudal system (the word literally means a shield tax) exigible by a feudal chief from others who owed him military service, as a cash payment in lieu of such service.

**SECURITY FOR TAX** — Where a taxpayer handles tax monies (PAYE deductions, V.A.T.) on behalf of a tax department, the question arises whether some security should be sought from the person involved because he is effectively in a position of trust regarding public money. In practice it is rather unusual for security to be actually sought by the tax department. Good tax administration, however, normally secures that where money is withheld at source in respect of income taxation, or in effect collected from customers by traders under a sales tax or V.A.T. regime, it should be handed over reasonably promptly after receipt.
In practice P.A.Y.E. tax is usually remitted monthly, sales tax and V.A.T. may be remitted monthly, quarterly, etc. according to the size of the amounts involved. In Brazil, where VAT (I.C.M.) is to a large extent collected by the banks on behalf of the administration, there are precise rules as to the number of days that may elapse between receipt by the bank and payment to the Treasury.
Where a taxpayer seeks to leave the country when he owes tax, and there is a genuine risk that the tax could not be collected in the event of his not returning, there is often provision in the tax law ensuring that some security be given by the departing taxpayer. See also PERIODICITY OF PAYMENTS, TAX CLEARANCE.

**SECURITY TAX** — In the 1970s, because of the prevalence of the hijacking of airliners by terrorists and criminals, many countries instituted body-searches and electronic surveillance of personal luggage in respect of passengers boarding aeroplanes at the main airports. Some countries have financed the cost of such security measures by a levy or tax on all passengers.

**SELECTIVE EMPLOYMENT TAX (S.E.T.)** — A tax which operated in the U.K. from 1966 to March 1973, in effect as a levy on the cost of services, with the stated object of encouraging the movement of employees from service industries to manufacturing industries, although some economists considered the latter already over-manned. The tax was levied at a relatively high specific amount (in a sense a "poll tax") in respect of each employee (initially £2.40 per week per man, £1.20 per woman or boy, £0.80 per girl; one-third only of the levy was made on elderly or part-time workers). The levy was payable by employers who were permitted to shift the tax to the consumer. The selective nature of the tax was in the refund system. Refunds of the total levy were granted to manufacturers, but none to service industries, while manufacturers in Development Areas were also paid a premium (see REGIONAL EMPLOYMENT PREMIUMS).

**SELF-ASSESSMENT** — See ASSESSMENT, SELF.

**SELF-CHECKING** — One of the merits claimed for V.A.T. is that because each trader pays tax on his sales and deducts the tax embodied in the purchases passed on to him by his suppliers, each trader has a vested interest in the accuracy of the certification to him of the tax paid by the traders from whom he purchases goods or services. This feature is thus claimed to be a means whereby the tax is "self-checking" or "self-enforcing".

**SELF-ENFORCEMENT** — See SELF-CHECKING.

**SELF SUPPLY** — In V.A.T. systems, e.g. that in the U.K., there may be a charge to tax on goods produced in the taxpayer's business which he uses himself. See also HOME CONSUMPTION.

**SELSKAB** — (Denmark) Company (Corporation).

**SELVANGIVELSE** — (Denmark) Income tax return.

**SEPARATE ASSESSMENT** — In the U.K. a husband is assessable on the joint incomes of himself and his wife, but a wife may elect to be separately assessed on her income, from which she will then be granted a proportion of the total reliefs. Somewhat similar provisions exist in the U.S.A. (see also INCOME-SPLITTING).

**SERVICE LIFE** — The period during which it is estimated an asset will provide useful service to the business in which it is employed. The rate of depreciation allowed will normally depend upon the length of service an asset may be expected to give.

**SERVICES TAX** — A tax, usually on ad valorem lines, on various types of services, sometimes included within the scope of a general sales tax including a V.A.T., but sometimes levied separately (e.g. the former French T.P.S. (Taxe sur la Prestation des Services)) and at other times a series of individual levies on different types of service often at different rates of tax; e.g. a higher tax may be charged on entertainments, particularly those of a luxury kind, gaming or betting taxes may be levied on casinos, horserace betting, etc., and there may be special levies on the stakes in football pools. The services of artisans may be exempted or charged at lower rates in some instances, and it is fairly common to exempt from tax the services of the liberal professions, including lawyers, accountants, doctors, dentists and architects.

**SEVERANCE PAYMENTS** — Non-contractual gratuities payable to an employee, usually on redundancy and usually non-taxable. (See, however, GOLDEN HANDSHAKE, GOLDEN BOWLER, also LOSS OF OFFICE, REDUNDANCY.) In Italy an employer may obtain a tax deduction for provisions made for severance payments which may arise, so long as the provision is in accordance with statutory and contractual obligations concerning employment. In Japan payments on cessation of employment, including lump-sum retirement or pension allowances, and severance payments, are taxed separately from other income. Deductions are made for the period of service (¥ 250,000 p.a. up to 20 years, ¥ 500,000 for each year over 20, plus ¥ 5,000,000) and tax is applied to 50 percent of the remaining amount.

**SHARE FOR SHARE ACQUISITIONS** — Where the shares in a company are taken over in exchange for the shares of another company which has assumed control of the first company, the "disposal" is often disregarded for capital gains tax purposes, though a charge may arise if the shareholder subsequently realises the shares he has received in exchange for the old ones.

**SHARE (STOCK) OPTIONS FOR EMPLOYEES** — Some companies allow directors and key employees to have an option to buy at some future date shares or stock in the company at a price usually in keeping with current stock market value. The theory is that those benefitting will have an incentive to make the company more profitable and thus enhance the value of its shares which they are enabled to buy at specified future dates at the option price.
The tax treatment of the difference between the market value and option price of shares under such schemes varies in different countries and over a period of time. For example, in the U.K. such gains were free of tax altogether until capital gains tax was introduced in 1965. Then in 1966 the gain was made chargeable to income tax. In 1970 some tax relief was given for formal schemes for share acquisition at fixed prices and there was further liberalisation in 1972. On a change of Government in 1974, however, the benefits were made taxable to personal income tax. Most countries tax the benefits in one way or another.

**SHIFTING OF TAXES** — In the case of indirect taxation the tax is normally intended to fall upon consumption and be borne by consumers, so that a trader who pays the tax on his sales or deliveries in general passes on the tax, or "shifts" it "forward", to the consumer by adjusting his prices appropriately. Such taxes are said to be shifted "backwards", particularly in the case of a new or increased levy, when some traders or manufacturers are forced to absorb some of the tax if they fear or find that their products are unable to bear an increase in price of the same dimensions as the tax because the demand for their products is elastic (see also TAX PUSH INFLATION).

**SHIP-MONEY** — A mediaeval tax for the support of the Navy, levied in Britain on coastal towns, revived by Charles I in 1634-36, when refused financial supplies by Parliament, and declared illegal by Parliament in 1641. Refusal to pay ship-money by John Hampden and others was among the events leading up to the Civil War of 1642-45.

**SHIPPING CENTRE** — A country which provides (inter alia) FLAG OF CONVENIENCE facilities for ship-owners and charterers. The tax pattern is usually exemption from income (company) tax on the profits from operating shipping, but fairly substantial registration or tonnage dues are charged on an annual basis. Usually the labour laws and other relevant legislation are less onerous in the haven country than in the countries of origin of the ship-owners. The term "shipping centre" is a euphemism adopted since Flag of Convenience vessels have become unpopular in some spheres, and the haven country may develop financial and other services for the benefit of the shipping companies.

**SHORTFALL ASSESSMENT** — A charge made on CLOSE COMPANIES (q.v.) in Britain prior to the 1972 Finance Act where the distributions made by such companies fall short of the statutory limits.

**SHORT-TERM GAINS TAX** — A number of countries tax short-term capital gains, generally defined as gains accruing from the acquisition and disposal of an asset, usually within a period of six months to two years (the period is six months in the U.S., 12 months in the Philippines while France and Sweden use a two-year period). Such gains are deemed by the tax law to be income chargeable with income tax, but in some systems may be charged at rates which are lower than income tax rates but higher than the rates applicable to gains which have accrued over a longer period.
At one time Britain taxed only short-term gains, there being no charge upon longer term gains. The tax law was specially designed to tax short-term gains which were defined as gains from disposals of securities which had been acquired within 12 months of the disposal date. As regards other property, gains were taxable if the disposal took place within three years of the acquisition of the asset. This tax survived the introduction of a general capital gains tax in 1965, but was finally repealed following the Budget of April 1971. (See also SPECULATION, LAND, TAX.)

**SIEGE SOCIAL** — (France) Residence of company.

**SIGHT ENTRIES** — The procedure whereby goods are allowed into a country by its customs officials, on an urgent basis, e.g. in the case of perishables, leaving full documentation and formalities to be completed later. (See also PERFECTION OF ENTRY.)

**SINGLE STAGE SALES TAX** — A sales tax which is applied at a single level of production or distribution, examples being the manufacturers' sales tax in Canada, the purchase tax in Britain and the retail sales taxes in the U.S.A. and Eire.

**SINGLE TAX** — A theoretical concept held by Henry George (1839-97) and his followers who advocated that all tax revenue should come from a single tax upon the increase in land values. In general, however, governments need to draw revenue from a number of different taxes, since the levying of all revenue by means of a single tax, whatever the tax base, would tend to be regarded as a rather oppressive levy. In practice, however, certain small countries, in effect, derive all their revenue from a single tax, notably the tax on minerals applied where the country has exceptional deposits of oil, phosphates or other minerals and the revenue derived from their exploitation is adequate to cover government expenditures because such revenue is large in proportion to the number of the population. In the U.S.A. over 80 percent of federal revenue is derived from the federal income tax, so that it is conceivable that the federal government could rely on a single tax if it were decided that other forms of revenue were undesirable, although present tendencies are rather in the opposite direction, adoption of a federal V.A.T. being mooted from time to time.

**SITE VALUE TAXATION** — A form of property taxation where the tax base is restricted to the value of the site, nothing being included for the value of the buildings or other improvements erected thereon. The tax is advocated by its proponents as a method of encouraging development, since the owner of a suitable site has no tax disincentive to deter him from developing the site to the limit of its capabilities. In practice, where site value taxation is in force it is often supplemented by an urban tax on buildings and the purity of the concept is in other cases diluted by provisions that when the total value of improvements to the site exceeds a certain percentage of the value of the site, site value tax will be payable on the value of the improvements as well as the site.
Use of the tax as an economic stimulus to development has proved of dubious value in practice. Developers tend to erect commercial or residential buildings when the time is judged right for being able to let them at a profit, rather than by reference to the degree of beneficence of the tax system. In any event PROPERTY TAX or RATES (q.v.) is normally shifted to the occupiers of buildings, not borne by developers.
In practice, also, where site value taxation has been used in developing countries it has often been found that the tax does not yield sufficient revenue to meet the budgetary needs of the taxing authority unless tax is levied at a rather high rate, which would accentuate anomalies in the tax structure.

**SITUS RULE** — A provision in a tax law, or in a DOUBLE TAXATION TREATY (q.v.), establishing in what place or country a source of income may be deemed to be situated for tax purposes. See also SOURCE RULE.

**SITZUNTERNEHMEN** — A company domiciled in Liechtenstein.

**SKATTEFRI** — (Denmark) Tax-free.

**SKATTELEMPELSE** — (Denmark) Abatement or reduction of tax.

**SKATTEPLIGT** — (Denmark) Tax liability.

**SKATTESVIG** — (Denmark) Tax fraud.

**SKATTETILSVAR** — (Denmark) Tax liability.

**SKATTEUNDDRAGELSE, LOVLIG** — (Denmark) Tax avoidance.

**SKATTEUNDDRAGELSE, ULOVLIG** — (Denmark) Tax evasion.

**SKATTEYDER** — (Denmark) Taxpayer.

**SKATTEÅR** — (Denmark) Year of assessment (tax year).

**SLAB SYSTEM** — A system of charging increasing rates of tax varying with increases in the taxable base such that the whole of the taxable sum is charged at the higher rate instead of successive slices or tranches being charged at a separate rate in the graduated scale. The slab system was used in connection with the estate duty in Britain until replaced by the slice or tranche system in 1969. Some countries still adhere to the slab system. The nomenclature is not universally adopted; some use the term "slab system" to mean what others would term the slice or tranche system. The definition of slab system given above is that adopted in the Green Book published in Britain in March 1972 on the "Taxation of Capital on Death".



**SLICE SYSTEM** — See TRANCHE SYSTEM.

**SMALL BUSINESS CORPORATION** — Under Section 1371 of the U.S. Internal Revenue Code a small business corporation is defined as a company with not more than ten shareholders, all of whom must be individual and none a non-resident alien and the company must only have one type of equity share. Such corporations may, in effect, elect to have the corporation income taxed as if it were the personal income of the shareholders.

**SMALL BUSINESS RELIEF** — Various types of relief tend to be made available in tax codes for small businesses. One economic factor in favour of special relief is that small businesses seem to have a greater capacity for rapid growth than larger ones and greater need to conserve capital for re-investment. In the U.K. there are concessions in the impact of CAPITAL TRANSFER TAX (q.v.), and a lower rate of corporation tax on corporate income applies up to a certain level. See also SMALL TRADERS, SPECIAL TAX REGIME FOR; SMALL BUSINESS CORPORATION.

**SMALL DISPOSALS RELIEF** — To reduce the administrative burden of operating a capital gains tax, disposals below a certain level of value may be excluded from consideration. The growing tendency, however, is to exclude a certain level of *gains* from the scope of the tax, this being a fairer way of exempting small gains from tax.

**SMALL INCOME RELIEF** — Apart from the basic personal reliefs granted in computing personal income tax, some countries establish an exemption limit somewhat higher than the reliefs due to a single person, so as to eliminate many small cases from the tax field. MARGINAL RELIEF (q.v.) may also be granted where the actual income is slightly above the exemption limit. In some tax codes higher exemption limits are also set for married persons, and those above certain age limits. The U.K., which was one of the pioneers of this system, has now abolished it in favour of higher personal reliefs. (See also ZERO BRACKET AMOUNT.)

**SMALL TRADERS, SPECIAL TAX REGIME FOR** — It has been a feature of some sales tax systems to make special provisions for small traders, defined as those whose sales are below certain limits. For example, in Federal Germany's V.A.T. system the small trader may opt to be assessed at a small percentage rate of his total sales, instead of on the ordinary V.A.T. system of paying a higher rate on sales and receiving a deduction for tax embodied in his purchases which has been passed on to him by his suppliers. Under the V.A.T. systems generally, traders whose sales are below a certain level are exempted altogether from V.A.T., while those whose sales are above the exemption limit but below a further "abatement" limit will have their tax bill abated by a formula which provides a sliding scale of abatement giving maximum relief where the exemption limit is slightly exceeded and the minimum relief where the upper limit is almost reached. Special regimes are also sometimes applied under income tax systems, somewhat simpler forms being required of the smaller trader than are expected from the large ones.

**SNAKE IN A TUNNEL** — The European Monetary System (EMS) which applies to most of the members of the European Economic Community (E.E.C.). While the currencies of the EMS countries may together vary against other countries freely, the value of each member country's currency with regard to other EMS members may only vary between narrow limits, in effect between the roof and floor of the "tunnel".

**SOCIAL SECURITY LEVIES** — Levies for social security may take the form of a tax such as a payroll tax on the total remuneration paid by an employer to his employees, which is not related to the circumstances of individual employees (see PAYROLL TAX) or may be a contributory scheme whereby the employer and employee contribute jointly for the benefit of the employee, whose ultimate benefits are specifically related to the contributions made by and for him. The third alternative is a scheme whereby compulsory contributions are made proportionate to the salaries and wages of employees, but the benefits are related to their circumstances at the time of retirement, for example, there may be a minimum pension for the lower grades of employees, the actuarial value of whose contributions would not have produced the level of pension granted.

**SOCIETÀ A RESPONSABILITÀ LIMITATA (S.R.L.)** — (Italy) A company whose members are liable only up to the nominal value of their quotas.

**SOCIETÀ PER AZIONI (S.P.A.)** — (Italy) A company whose members (shareholders) are liable for the company only up to the nominal value of their shares.

**SOCIÉTÉ CIVILE** — (France) A company formed as a partnership.

**SOCIÉTÉ HOLDING** — A holding company, especially those in Luxembourg, which receive special tax treatment.

**SONDERAUSGABEN** — (Germany) Deductible personal expenses.

**SOURCE RULE** — In a DOUBLE TAXATION TREATY (q.v.) it is customary to indicate, either in a separate article (the "source rule") or in a clause in each relevant article dealing with a particular type of income, which of the contracting countries should be regarded as the source country for such type of income.

**SØMANDSSKAT** — (Denmark) Seamen's Tax.

**SPECIAL CHARGE** — A charge which was imposed in Britain becomes payable on 1 January 1969 on investment incomes of more than £3,000. The levy operated in the form of an additional surtax charge which was applied in conjunction with the taxpayer's normal rates of income tax and surtax. The rates adopted were such that anyone receiving an investment income of over £15,000 had to pay more than 100 percent of it in tax; the charge thus amounted to a CAPITAL LEVY (q.v.) on those with investment incomes above that figure. The tax was similar to the SPECIAL CONTRIBUTION (q.v.) levied 20 years earlier.

**SPECIAL CONTRIBUTION** — A tax introduced in Britain in the 1948 Budget imposing tax at graduated rates on investment income. The tax was charged for the fiscal year 1948/1949 (payable January 1949) on the investment income of 1947/1948 where that income exceeded £250. The rates of tax were graduated up to a maximum of 50 percent which, when added to ordinary income tax and surtax, involved a total tax levy exceeding 100 percent, representing a CAPITAL LEVY (q.v.) on taxpayers with higher investment incomes.

**SPECIFIC DUTIES** — Customs and excise duties which are levied at a certain sum per unit, or per unit of volume or weight, are known as specific duties. Current examples include the duty in the U.K. on each mechanical cigarette lighter, which is a kind of COUNTERVAILING DUTY (q.v.) to the duties on matches avoided by using a lighter, and the duties on tobacco, and on alcoholic beverages, usually quoted as so much money per unit of weight or volume, respectively.

**SPECULATION, LAND, TAX** — A land speculation tax has been introduced in the Isle of Man to levy tax at the standard income tax rate on land and real property which is disposed of within five years of acquisition in the case of a non-resident, and within three years in the case of residents. The tax is charged on the excess of disposal price over cost and forms a SHORT-TERM GAINS TAX (q.v.).

**SPENDINGS TAX** — Another term for EXPENDITURE TAX (q.v.), i.e. a tax on the total amount of expenditure incurred, or money spent, on "consumption" by the taxpayer.

**SPLITTING, INCOME** — See INCOME-SPLITTING.

[to be continued]

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# STUDY OF TAX RATES

## Made at the Eighth Hispano-Luso-Americanas Meeting

by Enrique Jorge Reig*

## I. INTRODUCTION

During the Jornadas, a convention of Spanish and Portuguese speaking countries held in Buenos Aires in September 1979, discussions on the subject of tax rates took place. As an introduction to this paper we begin with a brief outline of the areas covered in the discussions on tax rates as well as the form and development of the dialogue that led to various conclusions on the subject. The objectives to be achieved by these discussions were stated in directives that were used as a basis for the analysis of the tax rates (either progressive or proportional), their structure and level (the amount of tax), but special note was taken of the type of tax — on income, capital, net worth or consumption — to be imposed and the ends to be achieved by its imposition.

In order to study the various factors that influence the rate structure of the different taxes, particularly the problems involved with public expenditures and public administration (especially the tax administration), a questionnaire and psycho-social study were prepared. This questionnaire, answered by the reporters from Argentina, Brazil and Uruguay, was a study of taxpayer attitudes that was included in the directives issued in order to form the basis of a comparative study of the tax rates in the participating countries.

Although many different factors that influence the tax rates were analyzed and their importance discussed they were not all included in the conclusions reached and recommendations made by the group. Such topics as the varying degrees of compliance and tax evasion that exist among the different countries were studied along with problems relating to public expenditure and public administration; however, no conclusions were reached on these subjects nor was a decision made on the actual effect of inflation upon the economies of the countries attending this meeting in the context of a comparative analysis of their tax systems and tax rates.

The materials used in this comparative study were the national reports. Because Argentina requested that they be submitted in advance it was possible to use them as a basis of the report. Among the ideas used in the analysis of the tax rates was Argentina's proposal that a mathematical formula be used in order to maintain continuous progressive rates, which provoked a lively and interesting discussion. However, before there could be any use of the proposed formula the whole question of whether or not taxation should be based upon a progressive scale had to be decided. In contrast to the utilitarian theory that looks at the usefulness of additional wealth or income to an individual or family group to determine the rate of taxation, the progressive tax theory rests upon a taxpayer's ability to pay the tax that is imposed upon him. The group considered a progressive tax rate therefore inherent to the general principles of equity that underlie taxation.

In order to determine clearly and precisely what is ability to pay taxes, as defined in the progressive scheme, the group devised an objective definition that was based upon the economic welfare potential of a given taxpayer. In

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* The author was assigned as general reporter and had the responsibility of preparing the directives used as a basis for the national reporters to produce their reports, and of presenting, as such, one paper to the congress. The meeting was held in Buenos Aires, September 1979.
He is Doctor in Economics and Professor of Public Finance and Taxation in the University of Buenos Aires. Dr. Reig is the author of: *Income Taxation* (seven editions); and *Sales Taxation* (six editions, the last on value added tax); he has acted as consultant for various tax reforms in Argentina and as private consultant as partner in charge of Drysdale, Reig & Vázquez Ger, correspondents in Argentina of Ernst & Whinney.

addition, in order to define the framework within which the rates were to be studied we agreed that the pattern that the progressive tax rate should take is dependent upon the current consensus and the political philosophy of the party in charge of the particular country in question at a given moment. Such is the case when, for example, a redistribution of wealth becomes an objective of the government's taxation policy; the progressive theory of taxation is then strengthened.

The recommendations proposed by the general reporter to facilitate the discussion on tax rates and to elaborate upon the conference's conclusions were made in 14 separate points, in addition to those made for each of the three tax groups (income, sales and exercise, capital and net worth) that comprise a modern system of taxation. Discussions were held based upon these points as well as the 17 conclusions that were finally approved by the Jornadas.

Because of the explicitness of the resolutions and the explanation contained in the preamble ("whereas" section) of the conclusion reached by the Jornadas it was not considered necessary to make comments on each of the individual proposals listed in the Recommendations. However, it was believed that it might prove helpful to review some of the considerations taken into account in the discussions of the different taxes.

### (a) Taxation on income

Recommendation 1, which deals with the pattern of progressive income tax rates, refers to the fact that it would be desirable to reduce the spread between the marginal and average tax rates in the middle range, in such a manner that it would also result in a reduction of the average rate of tax in the corresponding tax bracket. This was viewed as an indication of the pattern to be established by a progressive tax rate. This notion was based on the premise, accepted by all the participants in these discussions, that the tax produces a less adverse effect on the productive activities undertaken by the groups of taxpayers classified in the medium income brackets (income effect) in contrast to the effect it may have on those in the high level income groups (substitution effect).

Recommendation 2 also presented interpretational problems which were clarified in discussion. The suggestion that the exemptions and exclusions from the personal tax base be kept to a minimum only refers to their number but by no means to the fixed personal minimum exemption permitting a taxpayer and the members of his family a minimum subsistence level (i.e. a so-called "non-taxable minimum" and "family allowances"). It was only intended to recommend that the number of exemptions and franchises be kept as low as possible with a view to their effect upon the erosion of the tax bases in general. Neither was the suggestion meant as a comment on the policy behind the establishment of the personal minimum exemptions which may relate to the efficient administration of a great number of lower income taxpayers, whose exemption also is often justified considering the fact that they suffer from the proportionally heavier burden that consumption taxes impose on them.

Another interesting discussion resulted from the terminology in the writing of the resolutions due to the use of the term "rate". There was some confusion on the part of some of the participants as to its meaning. In the Spanish language, "rate" (tasa) is also a certain type of revenue. Therefore, it was noted, it was best not to use "tasa" in the text when the term was employed to refer to a portion of the share of the taxable base but that such words as "aliquotes" (alicuotas), "tariffs" (tarifas), or "types" (tipos) should be used instead.

An important comment on the type of rate that should be imposed on those who derive income from personal services was made by an Argentinian participant (see Recommendation 8). Because social security payments have become such an important governmental task and social security contributions constitute a significant portion of government tax revenue, it was suggested that coordination of income and social security contributions be made. In order better to coordinate and consider these two forms of taxation when establishing a rate and in order to follow equitable tax principles, the bases upon which both social security contributions and income tax are calculated for those with earned income should be similar.

Another important recommendation — Recommendation 6 — related to the taxation of corporations or businessses is that the income from a corporation or business should be included in the tax base for the progressive personal income tax; it was pointed out at the same time, however, that corporate income tax is not applied at progressive rates but only at proportional or uniform rates.

The Preamble and Recommendations 3, 4 and 5 show that the group was aware of inflationary aspects although it generally limited the analysis to those aspects more directly related to the effectiveness of tax rates and to the fulfillment of the tax obligations by the taxpayers. The participants agreed on the need to extend the remedies formulated in the tax rate area to other spheres of tax, e.g. non-taxable minimum and family allowances, loss carry forward provisions and exemption limits. The group felt that it was understood that the meeting was to be confined to a study of the tax rates, so that the discussions did not extend to these other phases of taxation.

### (b) Taxation on consumption

In the conclusions reached at the meeting, Recommendations 9 through 13 deal with consumption tax. It is interesting to note that despite the form this tax may ultimately take in the various countries, the recommendations all emphasized the need to keep the number of exemptions to a minimum. Because of the practice of allowing numerous exemptions to consumption taxes, higher rates than would otherwise result presently exist on those items subject to the tax. It was also suggested that these exemptions be limited to those that are absolutely necessary so as to reduce the burden of this type of tax upon taxpayers in lower income tax groups (that is, to reduce its regressivity).

In addition, after considering the importance of the type of tax, one must fix the rates (cumulative, one-stage, value added, etc.). It was decided that in the establishment of any form of consumption tax, it would be advantageous to both the tax administration and the taxpayer if only one rate were employed. Even though it was admitted that differentiated rates may be necessary to improve the distribution of the tax burden, it was also thought advantageous that their number be limited. They should be confined to two or three different rates and at the same time restrict the number of goods and services subject to another rate than the standard rate.

### (c) Taxes on capital and net wealth

The four Recommendations which were adopted with respect to the taxation of capital and net wealth, 14 through 17, voice the need for a progressive rate scale, structured similarly, as in the case of income tax, applicable to net wealth and inheritance taxes; in addition, they emphasize the supplementary nature of the individual net wealth tax to the income tax. It was therefore believed advisable, when establishing the rate of this tax, to take into consideration both income and net wealth taxes and to evaluate the additional burden of the tax upon capital income.

Another important proposal which was adopted refers to the inequity that results from the use of progressive tax rates levied on certain isolated types of property. One recommendation accented the need, when fixing the tax rate, to observe the principles of non-confiscation. Another expressed the need to note that the individual net wealth tax considers as part of the taxable net wealth of an individual his investment in shares of stock companies and his interest in any business enterprise. It was therefore believed necessary to integrate individual and corporate net wealth tax when a corporate net wealth tax is imposed as a method of making collection easier, so that corporate net wealth tax is considered as an integrated part of, and not a separate revenue, from the individual net wealth tax itself.

## II. THE BASIC CRITERIA USED IN THE ANALYSIS

The following discussion reproduces a substantial part of the general report, mainly from the section on the structure and level of tax rates. These were the basic criteria used in the analysis of the subject.

### A. Introduction

#### 1. Scope

The subject, "The tax rates applicable in the Spanish and Portuguese speaking countries", was analyzed from two points of view:
- the rate structure; and
- the limits or the maximum amounts that would be applicable.

The first problem encountered in the analysis is how should the tax burden be distributed among the taxpayers in keeping with the generally accepted principles of equity. This difficulty is recognized by Due and Friedlaender in their study of taxation when they remark: "What is "fair" or equitable in taxation is unavoidably a value judgement; no scientific specification of an equitable distribution pattern is possible."[1]

On the other hand, Due and Friedlaender point out: "the conflict created between equity rules and determined economic goals [such] as saving, investment and economic growth, could complicate the administration and compliance, to a point [at] which evasion could be of importance."[2]

The fundamental reason for choosing this subject for the Jornadas was to come to some conclusions about the adequacy of the structure and level of the tax rates currently in use in the countries which participated in this conference. This subject was therefore chosen in the hope that its analysis would aid in achieving compliance on the part of the taxpayers and with the expectation of reaching some conclusions and recommendations on the form and limits of the tax rates in keeping with the social and economic patterns that prevail in the interested countries.

Before analyzing the subject and the objectives to be achieved, it might prove useful to outline the current state of thought on the subject of fairness or equity in taxation.

#### 2. The equity principle

Equity or justice in taxation, as defined by Seligman, is generally discussed in relation to the problem of progressive taxation, which from the first half of the sixteenth century was based on the "ability to pay" theory.

A vast literature has developed on the subject of the impossibility of measuring the various benefits to the individual of the aggregation of additional wealth or income to that which he already possesses. The use of the notion of sacrifice as the basic for the test of the "ability to pay" has gradually been abandoned because of substantial defects. Thus, this theory is only studied from an academic point of view and has been replaced by the "faculty theory". Thus Due and Friedlaender[3] are of the opinion that the concept of sacrifice is irrelevant and reduce their anlysis of its impact to a footnote and base the theory of equity on the "ability to pay" theory, defining this within the framework of economic welfare.

Fagan in his works on the economics and theories of

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1. Due, John F. and Friedlaender, Ann F., Análisis económico de los impuestos y del sector público. El Ateneo, Buenos Aires, 1977, p. 219.
2. Due and Friendlaender, op. cit., p. 222.
3. Op. cit.

taxation[4] is clearly of the opinion that "ability to pay" is a separate and independent doctrine from that of measuring the sacrifice on the part of the taxpayer. He attributes the broader acceptance of the "ability to pay" theory to its higher degree of objectivity, although it maintains sufficient subjectivity to keep it in line with the "sacrifice" theory.

Neumark in his study on the principles of taxation[5] refers to the problem by declaring that the "ability to pay" should permit that the loss suffered by individual taxpayers because of the effect of the imposition of taxes upon their financial situation, be an equally onerous burden in relative terms after taking into account all the important personal factors.

The well known Carter Report on Taxation[6] defines the "faculty" theory using only economic criteria. It explains the "ability to pay" as proportional to the "discretional economic potential" of the taxable units; "discretional economic potential" is the product of the total economic capability that the taxable unit can contribute to the total expenses. In short, according to the Carter Report, the "ability to pay" is equal to the real and potential economic capacity of the taxable unit to acquire goods and services to the extent it is not required to support the members of these taxable units in a comfortable standard of life measured in relation to other taxable units.

Thus, the currently accepted view of the "ability to pay" theory is based upon the concept of measuring that part of the economic potential of the taxable unit that can be disposed of without affecting an adequate standard of living for the unit members. It is evident that this concept, by making itself more objective and disassociating itself from the "sacrifice" doctrine, does not give a solution as to the manner of distribution of the required tax burden. This will depend on the income to be used to cover necessities out of the total funds available in each stratum of wealth or income.

### 3. The redistribution effect

The use of the "ability to pay" principle as a basis for achieving justice or equity in taxation and in conformity with its definition involves a redistribution of wealth or income by the use of progressive taxes. But according to Neumark,[7] such redistribution is not in and of itself an objective of the "ability to pay" theory. Only when redistribution is considered a socio-political and ethical aim does any levy surpassing that which is necessary to accomplish such theory become different and acquire a separate identity. As Neumark mentions, this occurs when the distribution of the fiscal levies among individuals is progressive in a higher proportion than is necessary to fulfill the "ability to pay" theory.

The adoption of redistribution as a nowadays generally accepted objective of taxation starts with the premise that the distribution of wealth and income that occurs under free market conditions in a liberal economy is not the best and has a tendency to magnify the differences between the various social classes. Thus, the effect of redistribution transforms itself into a political end that is different from that of justice or equity, this being acceptable, according to Neumark, if the results, compared with the fundamentals of the economic order based on a market economy, are considered just in the general concensus. Thus the idea of justice also becomes part of the criteria taken into consideration when discussing redistribution.

The redistribution of wealth or income, on the other hand, is not the only objective that can be accomplished through taxation; to a significant extent it can also be achieved through a public expenditure program. In countries with developing economies where education, medical and hospital services, retirement pension funds and so forth are totally or partially financed at government expense, and these programs specially benefit the lower income class, do the government's expenses fulfill an important function of redistribution. This does not mean, however, that in order to obtain an income level that is considered "just" that the tax system could not be used in order to put into action such a plan.

## B. Structure and level of the rates

In analyzing the structure and level of the tax rates, recent American contributions in this area will be taken into consideration with respect to each of the following types of tax that form the fiscal system: income tax, consumption tax and taxation of capital and net wealth.

### 1. Structure of the rates

*(a) Progressive rates*

The problems involved in structuring the tax rates cannot be presented in a general manner because they are so closely related to each type of tax imposed.

The taxes on income and on capital, in the latter category particularly the taxes on inheritance and individual net wealth, demonstrate more frequently than any other type of tax the application of progressive tax rates. As a result, their imposition gives rise to the discussion on progressivity. On the other hand, consumption taxes are not consistent with the theory, and their fairness can be maintained only by the proper selection of exemptions from the tax or by the use of differentiated proportional rates of tax on groups of products that are consumed by the various income groups of the population.

There are three different methods of establishing progressivity, by groups or classes, by scales and by the

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4. Fagan, Elmer D., Recent and contemporary theories on progressive taxation, *Journal of Political Economy*, XLVI: August 1938, reproduced in *Readings in the Economics of Taxation*, selected by a Committee of The American Economic Association formed by Richard A. Musgrave and Carl S. Shoup. Richard D. Irving Inc., Homewood, Illinois, 1959, p. 12.

5. Neumark, Fritz, Principios de la imposición. Instituto de Estudios Fiscales, Madrid, 1974, p. 176.

6. The Carter Report. Spanish translation of the Report of the Royal Commission on Taxation. Kenneth L. Carter, President, Ottawa, Canada, Madrid, 1975, vol. II of the Spanish issue (3 of the Report), p. 5.

7. Neumark, Fritz, op. cit., p. 242.

linear or continuous method (without taking into account the use of exemptions on the basis, as this method is generally not utilised as a form of progressivity because they produce an unsatisfactory distributional curve).

The use of the progressive method of taxation for groups or classes of taxpayers is inconvenient. Measuring the tax on the basis of one rate for each group or class of taxpayer in each level of the scale leads to abrupt changes in the level of taxation when going from one group or class to the next causing inequities in the transition zones. Thus, it cannot be considered to be an acceptable manner to effect progressivity.

The second alternative, namely, the so called progressivity by scales, eliminates the anomaly which occurs under the preceding method. Progressivity is accomplished by increasing the marginal tax rates that are applicable successively to the taxable sums located between the lower and higher limits (i.e. "brackets") of each step in which the base of the tax is divided. This method undoubtedly has greater merit for which reason it has been generally accepted.

The linear or continuous method makes use of a mathematical formula that permits a more rational application of the progressive principle. Once the basic parameters are chosen it is easy to fix a progressive tax rate curve. This method is criticized, however, because of the difficulty to the taxpayers in applying it.

Taking into consideration the above, it was concluded that the analysis of the structure of the rates must focus upon the use of the progressivity by scales method. The variables to be considered in this analysis include:
— the number of steps (or scales) that must be established;
— the criteria to be used to determine the limits between the different steps; and
— the pattern to be used to increase the marginal rates in each step.

As the Kaldor report[8] demonstrated and as also is said in the conclusions of the Interamerican Conference where this work was presented[9] — and in most of the other studies on the use of progression for determining tax rates — it is better to limit the number of brackets in structuring the scale.

It is more difficult to come to any conclusion about constructing the scale, when this would mean determining whether the limits of each step must be constant or variable, and, if it is to be variable, then what would be the best pattern of variation.

The Carter Report[10] proposes that the brackets within the scale used for the imposition of income tax should be increased in geometric progression. This can be accomplished by multiplying by two each step on the scale in order to reach the next one until reaching the maximum rate within the individual scale. By so doing the large number of taxpayers who are located on the bottom of the income distribution pyramid can be divided into a reasonable number of brackets. The last of these brackets would be the largest and the number of taxpayers would be smaller. The resulting curve will reveal a rapid increase in the earlier steps and then a flattening out as it progresses.

However, we believe it would be difficult to determine with sufficient precision the rules necessary to establish the limits of each tax bracket which would also take into account the distribution of the taxpayers among the proposed brackets. The distribution of the tax base in the different brackets within the scale is a problem that effects both its limits, the highest and lowest, as well as fixing the marginal rate applicable in each bracket. The Carter Report proposed that in order to fix the marginal rates, the rates should increase step by step following an arithmetical progression, as long as the limits of the brackets grow progressively in a geometical trend. This is the most difficult area in which to make decisions about how to structure a progressive tax rate because they must not only take into account the general consensus in the respective country, in conformity with what is accepted to be fair, but they also must involve definitions on the redistribution of wealth and in achieving the socio-economic objectives that are being pursued in each country.

The National Report on Argentina for the Jornadas[11] incorporated what were believed to be the goals to be achieved by the introduction of a tax scale as proposed by Carter. Under this scheme the intermediate steps of the scale would be increased gradually but would then level off at the highest point. This method would reflect the principles of equity based on both the "ability to pay" principle and the socio-economic objectives.

This method may entail the least adverse effects on the incentive to work. Because of the "income effect", taxpayers in the lower income categories may increase their efforts whereas the imposition of heavy taxes in the higher tax brackets reduces re-investment and productivity. Several factors also come into play that can define the form of the step by step curve in the marginal rate scale. These factors include the total amount of revenue to be earned from the levying of the tax without, however, exceeding the previously established maximum rate of tax and the amount of income to be generated by the various steps.

Once having fixed the exact number of brackets to be established and the criteria to be used to determine the parameters of those brackets, the final element to be taken into consideration when forming the rate structure is to what rates will the marginal rates conform at each step. This must be done in order to arrive at the total tax due from the prospective taxpayer, which can be calculated by totalling the tax due in each step,

8. Kaldor, Nicholas, El papel de la tributación en el desarrollo económico, Reforma tributaria para América Latina, t. II, Problemas de política fiscal, Documents and Minutes of the Conference held in Santiago de Chile in December of 1962. Joint Program on Taxation OEA-BID-CEPAL, Panamerican Union 1964, p. 122.
9. Op. cit.
10. The Carter Report, vol. II, p. 10.
11. Prepared by Jorge Macon.

taking into consideration the bracket of the scale which the taxpayer reaches.

Once again a value judgement must be made on the principles of equity to be applied and of the socio-economic objectives that are to be achieved by taxation. In order to solve this dilemma the Carter Report proposes the use of a linear progressive ascending tax rate, with geometric progression to delineate the limits of each bracket. Nothing, however, in either instance should prevent the progression (in either the higher or lower brackets) from being constant over the whole length of the rate scale or being variable in its run.

Therefore, the only rule that can be recommended is that any formula to be adopted should be reasonable in order to justify any differentations that may be introduced so that they may not be seen as arbitrary or anomalous.

García Garzón demonstrated mathematically in his work on tax rates,[12] using the Argentinian income tax rates to clarify his analysis, that a steeper progression occurs immediately after a demarcation point than before. Consequently, this situation points to the fact that the progression is subject to as many ups and downs as there are divisions in the rate scale. His observation, based on this mathematical analysis, leads him to the conclusion that the system of progression by scales contradicts the theory of uniform progression and does not conform to the theory of a uniform reduction of the marginal utility of the successive amounts of income or wealth. This would seem to be a valid observation for any system that uses a progressive scale.

*(b) Proportional rates*

Up to this point there has only been a study of the progressive rates of tax; hereafter will follow a discussion of proportional tax rates which is a much simpler problem.

In general — and under the fundamental principles by which progressive rates were analyzed above — progressive rates are only acceptable when applied to income or property taxes levied upon an individual or family unit as the taxable entity. However, when taxes are imposed upon profits, business operations or isolated transactions (objective or real taxes), then progressive rates are not justifiable. The rates uniformly acknowledged to be acceptable for such types of taxes and that are used in various legislation when establishing tax rates are "proportional", also called "constant" or "uniform". This term is applied to either a tax levied as a percentage of values of the taxable base (ad valorem tax) or as an amount imposed on each unit of same (kilogram, meter, liter, etc. — specific tax), the percentage and amount not varying no matter what the size of the tax base. There are two structural problems that must be resolved when a proportional tax rate is to be applied. First a choice must be made between two different tax rate systems, either a single rate, or various rates applicable to sundry goods or services or groups of goods or services which it is considered desirable to tax differentially. The second problem is upon what basis should the tax be used, an ad valorem basis or a specific one.

The first decision to be made in the choice between a single or multiple rate structure was discussed in connection with rates for a general sales tax and more specifically with regard to the value added tax. The emphasis of the analysis of this problem was placed on the administrative problems caused by using a differentiated rate system. This same difficulty was discussed in 1971 at the Buenos Aires Conference held by the Joint Program on Taxation OEA — BID — CEDAL[13] which dealt with such topics as the *administrative criteria required to establish the structure of sales and excise taxation.* At that time comment was made upon the work presented by John F. Due[14] who pointed out the administrative advantages of using a single rate of tax. Not only does this method eliminate definitional problems which are similar to those which arise if exemptions are granted but it also prevents pressure which might be placed upon the Secretary of the Treasury by various interest groups seeking to change the position of their products on the tax rating lists.

On the other hand, as a controversial point for this analysis, the advantages afforded under a differentiated tax rate scheme can be evaluated. It enables a higher rate of tax to be imposed on non-essentials or luxury articles and in this manner it also helps to influence a better use for the country's resources. This variation in the rates, provided it takes into consideration the taxpayer's ability to pay the tax imposed on the items, would thus provide a way of introducing a certain amount of progression into the tax system which would in that way balance the fact that income tax is generally relatively less important in the Latin American countries.

The simplicity or ease of administration of one rate of tax is again demonstrated when applied to the problems of tax payments and tax inspection. With just one rate there is no need to classify different taxable operations into different groups subject to different rates of tax. This problem is particularly complicated when seeking to control the amount of tax credits in cases where multiple stage taxes are imposed and credit is given for taxes paid in the previous stages such as occurs under the usual form of value added tax.

Among the tax experts writing on tax rates, Due proclaimed himself firmly in favor of uniform rates of tax. In a paper presented at the First Annual Meeting of CIAT he said: "The use of a certain number of rates for the purpose of increasing the equity of the tax and decreasing the consumption of certain luxury articles, creates the same difficulties as the exemptions, interpretative problems with regard to the rate to apply and

12. García Garzón, Juan Oscar, Paper presented to the Jornadas, entitled Alícuotas en la imposición progresiva ("Rates in progressive taxation"). Mimeographic.

13. Programa Conjunto de Tributación OEA-BID-CEPAL, Reforma Tributaria para América Latina, vol. I, Problemas de Administración de Impuestos. Documents and minutes of the conference held in Buenos Aires, October 1961, Panamerican Union, Washington 1963.

14. Op. cit., p. 436.

causes complications in the taxpayer's compliance and application of the law."[15]

The model tax system proposed by the OEA in the Third Inter-American Conference on taxation, held in Mexico in 1972, also was in favor of the use of a single tax rate for the levying of a general sales tax accompanied by a selective tax on specific merchandise or services.[16]

It can be seen from the comments made on the proposed model tax system that there was a noticeable difference between the type of tax rates that should be imposed from Herschel's and Due's point of view.[17] Herschel gave preference to the "redistribution" effect of the variation in tax rates. He emphasized the results which would be achieved by the use of selective consumption taxes. Taxes on consumption, he believed, would serve an important function by influencing the direction of consumption. He therefore recommended that these taxes be given as broad an application as possible within the limitation imposed by the feasibility of its administration. Due, on the other hand, maintained that with any form of general sales tax, but especially with value added tax, a uniform tax rate is very important.[18] He then suggested that any selective tax on consumption should be limited to a relatively small number of goods and that the income tax was a better tool to use in order to achieve progressivity and redistribute income.

The above analysis exceeds the scope of the conference's topic (the structure of rates) for it is a discussion on the policy behind the establishment of tax rates. It must be emphasized, however, that this problem is an important one when decisions are being made on proportional tax rate systems. Because of the conflict between the goals sought to be achieved through the use of a tax rate that is administratively simple and just with those of a rate that will reflect economic goals and the redistribution of wealth, it is important to note that policy differences do exist and can be influential in making a decision on the type of system that will be used. This fact was demonstrated recently when Argentina announced that it was changing its hitherto two-rate value added tax system, in force since 1975, into a single rate of tax.

It must be confessed that it is difficult to come to conclusions on the subject of the structure of a system of proportional rates. The ease of administration and control of a single rate of tax clearly argues in favor of its adoption. On the other hand, in order to accomplish other objectives in developing countries, it is not always possible to realize such objectives through income or wealth taxes so that the use of various rates in consumption taxes is desirable.

Another problem that arises in discussion on selective or specific (excise) taxes on consumption is whether the rates imposed should be levied on an ad valorem or upon a specific unit basis. Specific rates of tax are still, however, the prevailing method of imposition despite the generally recognised advantages of using an ad valorem basis when imposing a tax on consumption, thereby using the sales values of the taxable good or service as the basis for levying the general sales tax, which is also a principal element for determining taxable income in the income tax.

During periods of inflation an ad valorem tax avoids the pitfalls that a specific tax on the taxable goods or services would have.

If a specific per unit tax were imposed on such goods or services during periods of inflation the tax would not keep up with the rapidly increasing rise in prices. The tax would therefore prove to be insufficient as a source of revenue. Under these circumstances such a tax would fail to achieve its stated goals because the basis of its imposition was expressed in units others than its real value.

As was mentioned in an earlier paper on the subject of taxes and inflation,[19] for the above-mentioned reasons Argentina changed in October 1976 to an ad valorem taxing system on a majority of the consumption taxes imposed by the government.

Since the functions assumed by modern states vary according to the prevailing political philosophy of the government which dictates the amount of governmental intervention necessary to provide general services, including the infrastructure needed to supply such services to its citizens, the general level of tax rates and its structure are also due to the role played by the government. In a state where socialist tendencies prevail, taxes generally are higher owing to the fact that the state provides many services that must be financed by the revenue from taxes. In contrast, in a non-socialist state public expenses are lower, therefore the state's need for revenue is lower, which results in a lower tax pressure.

Nevertheless, it is not only the degree to which the government needs to raise revenue, generally known as "fiscal pressure", that determines the level of the different rates of tax, but also the number of taxes that are imposed that determines such level.

In general, tax rates can be lower if the number of taxes is large. Therefore in a tax system in which there are numerous taxes the required revenue can be obtained even though the rates of the particular taxes are low. In contrast, in those systems where very few taxes are levied higher rates are imperative in order to raise the same amount of revenue. The amount of efficiency or lack thereof in the management of public funds is also a determination of the total amount of money needed by

15. CIAT, Centro Interamericano de Administradores Tributarios. Documents and Minutes de la Primera Asamblea General, 1967. Panamá. Volume issued in Buenos Aires, 1968, Paper entitled Estructura y operación de los impuestos sobre ventas, p. 445.

16. Programa de Finanzas Públicas de la OEA. Reforma Tributaria para América Latina, t. IV, La politica tributaria como instrumento de desarrollo. Documents and conclusions of the III Interamerican Conference on Taxation, General Secretary, OEA Washington, D.C., 1973, p. 17.

17. Herschel, Federico, volume mentioned in note 16, p. 210.

18. Due, John F., volume mentioned in note 16, p. 233.

19. Inflation and taxation. Paper presented as the National Report to the IFA Congress. International Fiscal Association, Cahiers, Vol. LXIIa, Rotterdam 1977, p. 191.

the state. Consequently the need to increase or decrease the taxes imposed under a given system of taxation is a direct product of this situation. This same efficiency factor is also an important point that can influence taxpayer compliance which must also be included in the calculations that fix the rates for the various taxes. It is a well known fact that because of all-pervasive tax evasion, governments are compelled to increase the tax rates thus placing a relatively heavy tax burden on honest taxpayers. However, other criteria also influence tax rates for there is a definite relationship between the amount of a particular tax imposed by a given fiscal system and the amount of revenue expected from other sources of the same system which, taken into account, influence any decision made on the structure and limits of the tax rates.

Finally, in an effort to give some structure to the discussion, the author feels that it would be appropriate to offer guidelines to be used for the analysis undertaken when a determination is made on what should be the extent of the tax rates applicable to the different types of taxes. It is well known that the steeper the tax rate the more the taxpayers are reluctant to pay the tax. Because of this, the first recommendation made with respect to the level of tax rates is that it should be kept within the level acceptable to most taxpayers. The rates, therefore, should not be so exorbitant that they would prove to be unacceptable to the taxpayers and thereby lead to a greater incidence of tax evasion. Taking into consideration the fact that the Carter Report[20] recommended that the maximum marginal income tax rate for Canada should be 50 percent, it is evident that in the countries represented at the Jornadas there is an exceptionally high rate of tax on income. Although these countries (based upon their gross national products) are poorer than Canada, their tax rates in many cases are the same as or even higher than those in Canada.

On the other hand, this observation must be tempered by the following considerations. First of all, there is no uniform tax base in the various countries as a result of, for instance, the individual governments' policy towards tax exemptions or because of the fact that dividends distributed by joint stock companies are not included in the tax basis for the computation of individual progressive income tax.

Secondly, some taxes have political restraints placed on their imposition. For example, taxes on property owned or transferred as a result of an inheritance are frequently resisted on the basis of the philosophy that taxes should not be so excessive as to become confiscatory. This concept is often seen in the individual national constitutions such as in Argentina in which the inviolability of private property is guaranteed.

When considering taxes on consumption the reason behind the restrictions placed on their level seems to be mainly the attitude of the taxpayer towards the rate of tax. This is so except in those types of multiple stage cumulative taxes (e.g. "cascade" taxes) where there is an additional element to take into consideration: the tax must not distort the form of business organisation (vertical integration). For other taxes, e.g. customs duties, that are imposed for reasons of protection, or an expenditure tax used to lower consumption, rather high rates can be imposed that even exceed 100 percent when they are in keeping with the purpose of the tax.

## III. CONCLUSIONS OF THE JORNADAS

### Preamble

The following 17 recommendations were made as a result of the discussions held during the Jornadas (summarized in part 1 of this paper). Most of the proposals upon which the recommendations are based are included in the general report to the Congress but are not reproduced herein due to the fact that they are very similar to the ones approved.

The recommendations are as follows:

Whereas

1. The papers were presented to these Jornadas by the national reporters from Argentina, Mr. Jorge Macon; Brazil, Mr. Ives Gandra Da Silva Martins; Chile, Mr. Juan de Dios Vergara Baeza; Spain, Mr. Mariano Sebastián Herrador; Mexico, Mr. Javier Moreno Padilla; Portugal, Mrs. Antonio Joaquín Carvalho and Mr. Manuel Henrique de Freitas Pereira; and Uruguay, Mrs. Betis Inglés de Forecella and Mr. Horacio Fernández Susena.
2. The technical communications were added by Mr. Juan Oscar García Garzón, Mr. Saúl Witis, Mr. Ricardo Calle Saíz, Mr. José Alberto Parejo Gamir, Mr. José Luis Perez de Ayala and Mr. Angel Schindel.
3. The report of the general reporter, Mr. Enrique Jorge Reig, was presented.
4. The propositions and suggestions offered during the discussions that took place during the working sessions of the Commission have been compiled.

Considering

1. That the problem of the tax rates, tariffs or types[21] of tax is based upon a series of factors the most significant being, first, the dominant political philosophy in the particular social-economic community in which it is employed which determines the level of taxes imposed on the taxpayer and, second, the consensus which is reached in that community on the criteria to be used to judge the fairness of the distribution of the tax burden among the population.
2. That it is the efficiency of the government in managing and directing public expenditure, as well as the reasonableness and efficiency of the public administration, in particular the tax administration, that are important elements in establishing differentiated tax rates, which because of their sensibleness will be capable of obtaining the acceptance and the compliance of the taxpayers.
3. That the presence of inflation in most of the

20. The Carter Report, vol. I (1 and 2 of the Report), p. 277.
21. See introduction for the term "tax rates, tariffs and types".

countries attending this meeting makes it necessary to take into account the distortions it causes in the distribution of taxes and in the taxable base, affecting the fairness that was envisioned when establishing the taxes and the taxpayer attitude with regard to compliance.

4. That likewise, before analyzing the problem of the tax rates and tariffs and types,[22] to achieve an effective imposition of these taxes in the desired amounts as foreseen by the legislature, it is necessary to stress the fundamental importance of the correct and uniform determination of the taxable base.

   In economies suffering from inflation, the rules for estimating the taxable base ought to refer to the same period of time whatever the taxable matter, so that may reflect, for the particular tax, the taxpayer's ability to pay; the time of payment also should be fixed to correspond with the moment the tax arises in the different taxpaying sectors and in the different taxes. If this is not done distortions would result from the failure to consider the abovementioned factors, so that the fairness sought by distributing the taxes among different sectors of taxpayers is lost and compliance with the obligation of paying taxes is disturbed along with those objectives sought to be achieved by the tax.

5. It must be emphasized that taking into account in the tax system the distortion caused by inflation is not meant to imply an acceptance or agreement with the latter and, on the contrary, fiscal policy as one of the instruments able to do so ought to be utilized to fight inflationary trends.

   The fiscal adjustment of the distortions produced by inflation helps to maintain adequate tax collection levels and to prevent treasury deficits.

6. That the economic and social objectives which are at present achieved through the use of taxation can, in connection with the public expenditure policy, achieve a redistribution of wealth and economic stability and development, intended to improve the well-being of all, also establish general guidelines related to rates, tariffs or types of tax.

7. Before formulating any recommendations about the structure of tax rates, it is felt that given the harmful effect that tax evasion has upon the achievement of the above-mentioned purposes of taxation, as well as being the cause for an increase in tax rates by governments wishing to maintain a specific level of revenue, it is necessary to think about the desirability of funding programs to educate the public on the need for taxes since such knowledge may encourage compliance by giving them a proper picture of the functions of taxation and public expenditure in a modern society.

In view of this, the Eighth Meeting on Tax Studies of Spanish and Portuguese speaking countries recommends the following:

## Recommendations

*The meeting recommends the following guidelines that must be taken into consideration, when structuring the rates of the various taxes:*

### (a) Income taxation

1. *Individual income tax should be progressive through the use of a system of scales in which the rate applicable in each bracket exceeds the rate in the preceding bracket but in which the marginal rate gradually approaches the average rate thus taking into account the distribution of the taxpayers' incomes.*

   *The rationale for the differences in the width of each bracket, the marginal rate and the number of brackets, should reflect the prevailing consensus on the fairness of the tax, the policy of redistribution of the country's wealth, the administrative efficiency of the tax and the taxpayers' compliance.*

   *However, this proposed scale system bears an inherent structural conflict since on the one hand it should for simplicity's sake have as few brackets as possible, whereas on the other hand an adequate continuity of graduation would require a large number of brackets. This does not mean that the advantages of the continuous or linear scale method are ignored but it is advised to continue research with the view of finding a simple formula enabling its practical application.*

2. *Exemptions or exclusions from the taxable base of the individual income tax should be kept to a minimum so that it would not be necessary to raise the tax rates in order to maintain a determined level of tax revenue.*

3. *In view of the fact that inflation is present in most of the Spanish and Portuguese speaking countries, in order to maintain the level of the tax imposed on the taxpayers there should be a permanent adjustment made in the tax brackets of the progressive scale to compensate for this inflationary trend.*

4. *In cases where inflation turns out to be significant and permanent, in order to eliminate its effect and the lack of compliance on the part of the taxpayers with the resulting loss of revenue and a probable fiscal deficit, it would be desirable to use a system that adjusts the debts owed and credits granted, and taking into account the inflation in the calculation of the advance payments of taxes, when these are based on figures declared in the previous year's tax return.*

5. *Similarly, with respect to taxable bases during periods of inflation, they too should be adjusted to avoid distortions.*

6. *The corporate income tax should be applied at a "proportional" or "uniform" rate since progressive rates are not considered to be appropriate for corporations, and also encourage its artificial structural division. However, as was recommended by the Fifth Jornadas (held in Cordoba, Spain in October 1972), corporate income, at the moment it is*

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22. See note 21.

considered to have been distributed to the shareholders or partners, should be taxed at the progressive rate levied on the individual income tax.

The rates of the capital gains tax ought to relate to those of the regular income tax, and in order to avoid distortions caused by inflation, the tax adjustments should also apply in a manner similar to that proposed for regular income tax. Preferably, capital gains should be included as part of the taxable income. In order to correct the impact that a progressive tax rate would have upon earnings that have accrued during periods of over a year, among the several suggestions proposed, the most acceptable was considered the so called "pro-rata system" that might be used to modify such impact.

In cases when income is derived from personal services and social security contributions are paid based upon this income, the similarity between the bases of these contributions and income tax should be taken into consideration in order to co-ordinate and integrate them upon the principles of tax equity.

(b) Taxes on consumption (sales and excise taxes)

It would be desirable that a change be made in the form of tax used, in countries which have adopted a cumulative multiple stage or cascade general sales tax so that these taxes are applied only once to the price. In this way distortions could be avoided in the organization of businesses caused by cumulative taxes and the taxpayers' attitude towards compliance could be improved in particular when the rates are significant.

10. At present due to the great number of exemptions that frequently exists in the various types of multiple and single stage sales taxes including VAT, higher rates of tax are required on those items which are subject to tax. Therefore, it would be advisable to reduce the exemptions, limiting them to those which are unavoidable to lessen the regressivity of the tax.

11. When establishing the appropriate size of the proposed tax rate, besides the fiscal purpose of the tax, the type of sales tax should be taken into consideration and whether it should be cumulative or not in different stages of the economic process as well as at what stages it will be placed, in order to avoid any possible economic distortions between the numerical amount fixed as the rate and the actual incidence of the tax. In addition, taxes similar to a sales tax imposed by different levels of government such as the provinces or the municipalities should be taken into consideration when determining the rate of the proposed tax.

12. Due to the advantages to both the tax administration and the taxpayer of a one-rate tax it would be desirable not to use differentiated rates based upon the ability of the taxpayer to pay as revealed in the consumption of the taxable goods or services. Nevertheless, when it may be necessary to have graduated rates as a means of improving the distribution of the tax burden among the taxpayers, it would be advisable to limit the number of tax rates to two, or at the most three. Likewise it would be advisable to reduce the number of such goods and services subject to such different rates.

13. It is also advisable with respect to specific excise taxes, that only a limited number of goods and services be included under this special category of taxation separated from the general sales tax. In order better to achieve the purpose of distributing the tax burden according to the "ability to pay" principle and to avoid rates lagging behind, attention should be paid to the possibility of transforming specific per unit taxes into ad valorem ones. For this type of tax the rate can be much higher than those used in the general sales or consumption tax, this tax being levied upon sizeable taxpayer units and its aims are different from those of other such taxes.

(c) Taxes on capital and net wealth

14. The criteria listed in paragraph 1 under income taxation are also applicable to any plan to use progressive scales for wealth, inheritance and gift taxes. By taking into consideration the complementary nature of the individual net wealth tax with regard to the income tax, the wealth tax rates should be significantly lower than those of the income tax so that the total tax burden, considering jointly both taxes, would be a reasonable one.

In those countries that levy taxes on inheritances and gifts, the same criteria used for structuring progressive scales should be used to plan these rates in addition to the traditional criteria that take into consideration the degree of familial relationship, with the lower rates assigned to transfers between parents and children and to direct ascendants and descendants.

15. The rates of tax on inheritances and gifts as well as net wealth should be graduated so that the results are not confiscatory, a principle which determines a limit to the rates, varying this according to the prevailing opinion of what is the purpose of the tax in the pertinent country.

16. Real property tax and other taxes levied upon determined properties should not use progressive rates when the tax is based upon the isolated value of the property, because they are taxes on goods or things as opposed to personal taxes. Progressive rates are better applied to those taxes to which individuals or families are subject on all or a major part of the properties they possess, less deduction of debts, among which the individual net wealth tax is the most complete expression.

17. It is advisable that the tax on a company's net worth should use proportional or uniform rates for the same reasons expressed above in point 6 under the discussion of corporate income tax. Furthermore, capital invested in companies subject to net worth tax should integrate the net worth tax base with the individual net wealth tax imposed upon its shareholders and partners.

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# ALLOCATIONS OF FOREIGN BLOCKED INCOME UNDER UNITED STATES TAX LAW

by Howard M. Liebman *

*In two recent Private Letter Rulings,* [1] *the Internal Revenue Service (IRS) has taken a position which not only raises a number of conceptual difficulties but may also create significant practical problems for taxpayers doing business with affiliates in countries which have stringent exchange control regulations. In both rulings, the IRS National Office issued Technical Advice Memoranda which supported an allocation of income from a foreign subsidiary to its U.S. parent even though the local law of the foreign country had precluded such payments.*

## THE BLOCKED INCOME ALLOCATION RULINGS

n the first ruling (No. 7923003), [2] the U.S. taxpayer ad entered into two technical assistance contracts ith its subsidiary in an unnamed foreign country. These ontracts required the U.S. parent to provide the ientific and technical information and documentation ecessary to manufacture, process and sell certain proucts. In return, the foreign subsidiary was obligated p pay a technical assistance fee in the amount of 5 ercent of the revenues generated from the sale of ich products. The agreements were to last for five ears and, if permitted under local law, could be exnded for an additional five years. The agreements ere specifically subject to the laws of the susidiary's ost country.

nder the latter's governing law, however, the maximum llowable fee in any particular case could be varied by e authorities, although it could in no event be higher an 5 percent. The law also allowed the authorities to mit the duration during which technical assistance es could legally be paid. This law applied to dealings oth between related parties and unrelated parties. The levant authorities in this instance had reduced the llowable fee to 4 percent in the case of one contract nd 2 percent in the case of the second contract, and, addition, had shortened the duration of both of em. [3]

evertheless, the IRS ruled that if the payments which ere allowed under local law did not constitute arm's ngth charges, Section 482 of the Internal Revenue ode of 1954 (I.R.C.) [4] could be used to allocate dditional income to the parent despite the fact that e foreign law prohibited the payment of such additional income. The ruling does not itself state what e arms length fee should have been, but it does note that the amount of any allocation need not be limited according to the terms of the technical assistance agreements. Any such allocation should instead be based upon all the facts and circumstances surrounding the rendering of the services and the transfers of intangible property in question, applying the standards set forth in the Treasury Regulations. [5] Thus, under this ruling it is conceivable that the arm's length charge could be determined to be in excess of the 5 percent fee provided for originally in the two agreements, despite the absolute upper limit of 5 percent established by the applicable foreign law.

In the second ruling (No. 8001017), [6] a similar factual background was presented. A foreign subsidiary of a U.S. corporation had entered into a license agreement with its parent under which it was to pay royalties to the latter. Subsequently, the foreign country enacted a law whereby all royalty payments to foreign affiliates or parent companies were prohibited. The law also limited the amount of net dividends payable to foreign shareholders. For this reason, the U.S. taxpayer amended

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1. IRS Priv. Ltr. Rul. 7923003, Feb. 22, 1979, noted in Fuller, *U.S.: IRS Private Letter Ruling Report*, 80-1 INT'L TAX REP. 1 (Jan. 28, 1980); IRS Priv. Ltr. Rul. 8001017, Sept. 28, 1979, reprinted in [1980] 10 STAND. FED. TAX REP. (CCH) ¶ 6954, noted in 7 TAX PLANNING INT'L 60 (March 1980).
2. See note 1.
3. The approved durations were not specified in the ruling.
4. "In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses." (26 U.S.C. §482.)
5. See Treas. Reg. §§1.482-2(b) (services); 1.482-2(d) (transfers of intangible property). See generally Surrey, "Reflections on the Allocation of Income and Expenses Among National Tax Jurisdictions", 10 L. & POL. INT'L BUS. 409, 420-424 (1978).
6. See note 1.

its license agreement to suspend the payment of royalties until such time as they would no longer be prohibited under local law. [7] Once again, the IRS ruled that the income "may be allocated under Section 482 of the Code to ...[the U.S. parent] from .... [the foreign subsidiary] even though ... [the foreign subsidiary] is prohibited under the laws of ... [its corporate domicile] from paying such royalties". [8]

## II. THE IRS' RATIONALE

The IRS has opted for doctrinal purity of sorts in issuing these two rulings, implying that the overarching principle of the arm's length standard should be sufficient reason to ignore the constraints of foreign law. Instead of offering any further analytical insight into such a proposition, however, both rulings merely concentrate on distinguishing the precedent established by the Supreme Court in the case of *Commissioner v. First Security Bank of Utah, N.A.* [9] That case involved an attempt by the IRS to allocate commission income to two national banks as a result of credit life insurance policies which their customers had purchased from a related, non-bank subsidiary which was a licensed insurance carrier. The Court took note of the fact that it was a customary practice for a sales commission to be paid by the insurer to the party which had sent it the business. Nevertheless, by a 6-3 majority, th Court refused to uphold the IRS allocation on the grounds that, legally, "the Banks could never have received a share of these premiums". [10] The reason for this restriction was found in Federal banking law, which had been interpreted in a number of court decisions as prohibiting a Federally-chartered bank from acting as an insurance agent unless it was located in a very sparsely populated area. The IRS had not contested the fact that the taxpayer-banks were covered by this prohibition. As the Court could find no precedent "wherein a person has been found to have taxable income which he did not receive and *which he was prohibited from receiving*", [11] it therefore would not sanction the allocation in question.

The IRS has sought to distinguish the *First Security Bank of Utah* case on the grounds that the latter only applies when it is illegal for a taxpayer to receive the income "under the laws of the United States". [12] Both Private Letter Rulings use the exact same language in this regard. Relying on a previous published ruling, [13] they both asset that:

> *It is the position of the Service that the restriction on the Commissioner's authority to allocate under Section 482 set forth by the Supreme Court in* First Security Bank of Utah *is limited to that situation where the taxpayer is prevented from receiving income under United States law.* [14]

Given this interpretation, the IRS has no difficulty in finding that I.R.C. Section 482 may be applied to allocate income among related taxpayers when it is a foreign law which prevents the receipt of the income in question.

## III. A CRITIQUE OF THE IRS POSITION

An analysis of the decision in *First Security Bank o[f] Utah* would appear to indicate that the IRS' narro[w] interpretation is entirely misdirected. The basis f[or] the Supreme Court's decision lay in the fact that th[e] taxpayers could not legally receive the income bein[g] allocated. [15] Although the Court naturally explaine[d] why the taxpayers were prohibited from receiving th[e] income and therefore discussed the U.S. Federal law[s] which were behind the prohibition, the Court's rational[e] is entirely unrelated to whether the U.S. or foreign la[w] is the grounds for the prohibition. According to th[e] Court, "[t]he underlying assumption always has bee[n] that in order to be taxed for income, a taxpayer mus[t] have complete dominion over it". [16] The decision the[n] restated the principle propounded in the seminal case o[f] *Corliss v. Bowers*, [17] namely:

> *The income that is subject to a man's unfettere[d] command and that he is free to enjoy at his ow[n] option may be taxed to him as income whether h[e] sees fit to enjoy it or not.*

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7. The ruling states that in anticipation of the entry into forc[e] of the new law, the U.S. parent had first amended the licens[e] agreement in order to increase the royalty rate and that it i[n] fact collected this increased rate for at least one year pric[r] to the blocking of all further payments. IRS Priv. Ltr. Ru[l.] 8001017, see note 1.
8. Idem.
9. 405 U.S. 394 (1972) (per Powell, J.), 1972-1 C.B. 135.
10. Idem, 1972-1 C.B. at 137.
11. Idem, (emphasis added). See also Beecham, Inc. v. U.S[.] 73-2 U.S.T.C, ₱ 9719 (E.D. Tenn. 1973). It should be noted th[at] the decision in *First Security Bank of Utah* was not received wit[h] entirely favorable reviews. One commentator criticized it f[or] ignoring the basic thrust of I.R.C. Section 482 and for lackin[g] "foundation in the relevant case law". 14 B.C. IND. & COM L. REV. 165, 168 (1972). See also Aland, "Can IRS Use Sectio[n] 482 to Allocate Income which Cannot be Earned under Ap plicable Law?", 52 J. TAX. 220 n.2 (1980).
12. IRS Priv. Ltr. Rul. 7923003, see note 1; IRS Priv. Ltr. Ru[l.] 8001017, see note 1.
13. Rev. Rul. 76-243, 1976-1 C.B. 134.
14. IRS Priv. Ltr. Rul. 7923003, see note 1; IRS Priv. Ltr. Ru[l.] 8001017, see note 1. Cf. IRS Priv. Ltr. Rul. 8003011, Oct. 4 1979, reprinted in [1980] 10 STAND. FED. TAX REP. (CCH ₱ 6966 (in the context of a Subpart F question, the Servi[ce] applied the *Biddle* rule from the foreign tax credit areas, viz *[I]n the application of United States income tax laws, the co[n]cepts established by that body of law are controlling, despi[te] the fact that a particular transaction under consideration ma[y] have had its origin in a foreign country and, to that extent, ma[y] have been affected by a foreign income tax law.* Query whether this same principle can also be extended t[o] other areas such as I.R.C. Section 482.
15. See the discussion in the text at notes 10 and 11.
16. Commissioner v. First Sec. Bank of Utah N.A., see note 9 1972-1 C.B. at 137.
17. 281 U.S. 376, 378 (1930). See also Helvering v. Horst, 31[1] U.S. 112, 116 (1940) (taxable income includes that which [is] constructively derived by the taxpayer from the "use or di[s]position of his power to receive or control the income as t[o] procure in its place other satisfactions which are of economi[c] worth").

The Court noted that the Treasury Regulations under I.R.C. Section 482 reflect this principle in assuming that the Commissioner's reallocation authority is to be utilized in cases of related taxpayers which have "complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income..." [18] But, as the Court concluded, this assumption of "complete power" cannot be extended to include "the power to force a subsidiary to violate the law". [19] Thus, the Court felt that "fairness requires the tax to fall on the party which actually receives the premiums rather than on the party which cannot". [20] In view of the Court's broad rationale, it is difficult to understand how the IRS can limit the decision to cases in which the prohibition involves U.S. law. [21] The fact that the prior case law only discussed the issue in terms of U.S. law is also no reason to hold that the general principle should be narrowed since such prior cases naturally reflected the facts and circumstances at issue, and the fact that such cases involved U.S. as opposed to foreign restrictions was a mere fortuity. [22]

To a certain extent, the recent decision of the Sixth Circuit in the case of *Salyersville National Bank v. U.S.* [23] highlights this point. In that case, the IRS attempted to allocate commissions for credit life insurance premiums paid by a bank's customers to the bank although the purchases were effected by the bank's president, a licensed insurance agent. Federal law was inapplicable since the taxpayer was not a national bank. Instead the taxpayer argued that it was prohibited under Kentucky law from receiving the commissions since it was not a licensed agent. For at least part of the taxable period in question, it was in fact barred by state law from becoming an insurance agent. Although the state insurance code was subsequently amended, the taxpayer had not qualified as an agent under the new law and therefore remained barred from earning or receiving commissions. The IRS argued and the District Court agreed that once the bank was no longer precluded from becoming an insurance agent, an allocation was permissible. Basically, the IRS took the position that "if the bank had the capability of making itself eligible to receive any commissions it was required to do so, even if it could legitimately choose not to do so". [24] The Sixth Circuit refused to accept this argument, however, and reversed the decisions, including *First Security Bank of Utah*, for the principle that a taxpayer need not arrange its affairs so as to maximize its tax liability. [25] In fact, quite to the contrary. [26] A taxpayer may lawfully structure its business in such a way as to minimize its taxes as long as there is a legitimate business purpose in doing so. [27] In this case, the taxpayer was able to provide a number of reasons why it would prefer, as a business decision, not to qualify as an insurance agent -- e.g. insulation from primary liability on the insurance policies; avoiding the requirement to pay fees, and avoiding the necessity of amending its charter if it were to engage in the selling of insurance. The IRS, on the other hand, did not provide the Court with any authority for why the taxpayer should be required to have qualified as an insurance agent. [28] Thus, the Court, after having determined that it would have been illegal for the taxpayer to have received the commissions being allocated to it, determined that the allocation was impermissible. Naturally, it relies heavily on the precedent established by the decision in *First Security Bank of Utah*. In so doing, it interprets the latter in its broadest sense. [29] It does not get stuck at all on the question of whether the Supreme Court only intended the case to apply to banking law, "Federal banking law", federal law in general, or any U.S. (including state) law. [30] Nor do other cases which rely upon the *First Security Bank of Utah* precedent in any way interpret the latter as implicitly having certain geographic limits to its applicability. [31] In fact, the case was even applied to preclude the IRS from attempting to allocate credit life insurance commissions using I.R.C. Section

18. Treas. Reg. §1.482-1(b)(1).
19. Commissioner v. First Sec. Bank of Utah N.A., see note 9, 1972-1 C.B. at 138.
20. Idem.
21. The only time the Court makes such a limiting reference is when it noted that the taxpayer, in effect, lacked the power to shift income among its subsidiaries, "unlessit acted in violation of federal banking laws". (Idem.) But this phrase if probably intended as a statement of fact and not of principle. If it were to be treated as a statement of principle, its effect would be even more restrictive than the principle which the IRS has attempted to invoke. At the very least, it would mean that the case could only stand as precedent in the event of prohibitions under U.S. Federal law. The Supreme Court's opinion has not been interpreted so narrowly however. See, e.g., Salyersville Nat'l Bank v. U.S., below note 23, and the discussion in the text at notes 23-28 below (prohibitions under state law).
22. For example, the Supreme Court in *First Security Bank of Utah* discussed the case of *L.E. Shunk Latex Products, Inc.*, 18 T.C. 940 (1952), *acq. in part and nonacq. in part*, 1953-1 C.B. 6,7 *Comm'r's appeal dismissed nolle prosequi* (June 5, 1953), in which an IRS attempt to allocate income to a taxpayer was frustrated by the OPA Price Regulations of World War II which prohibited the former from increasing its prices.
23. 80-1 U.S.T.C. ₱ 9190 (6th Cir. 1980), *rev'g* 77-2 U.S.T.C. ₱ 9711 (E.D. Ky. 1977).
24. Idem, 80-1 U.S.T.C. at 83,273.
25. Idem., 80-1 U.S.T.C. at 83,274.
26. It is well established that a taxpayer may legally "decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits...". Gregory v. Helvering, 293 U.S. 465, 469 (1935).
27. Salyersville Nat'l Bank v. U.S., above note 23, 80-1 U.S.T.C. at 83,274. Cf. Hansche v. Comm'r, 457 F.2d 429, 433 (7th Cir. 1972) (taxpayer may arrange its affairs to minimize or eliminate tax, although the IRS is not bound to accept "self-serving" characterizations).
28. Salyersville Nat'l Bank v. U.S., above note 23, 80-1 U.S.T.C. at 83,276. 83,276.
29. In *CIR v. First Security Bank of Utah*, 405 U.S. 394 (1972), the United States Supreme Court held that income could not be reallocated to a taxpayer who did not receive the income and who could not lawfully receive it. Idem, 80-1 U.S.T.C. at 83,275.
30. The *First Security Bank of Utah* decision has been applied as an analogy in other State law contexts as well. See, e.g., Delta Life Ins. Co. v. U.S., 363 F.Supp. 410, 73-2 U.S.T.C. ₱ 9663 (E.D. La. 1973) (computation of life insurance reserves pursuant to I.R.C. Section 801 under governing State law).
31. See, e.g, U.S. v. Basye, 410 U.S. 441, 73-1 U.S.T.C. ₱ 9250, at 80,478 n. 13 (1973). See also Aland, above note 11, at 221.

61[32] instead of I.R.C. Section 482, when such commissions could not be received by the taxpayer bank under state law.[33]

On a more basic level, the absence of any inherent distinction between the effect of foreign as opposed to U.S. law in invoking the *First Security Bank of Utah* principle should be clear from the fact that I.R.C. Section 482 does not itself distinguish between foreign or wholly domestic transactions. Thus, the general principles should be the same in both contexts. Admittedly, the fact that a foreign transaction is involved may have an effect on the precise calculation of what an arm's length consideration should have been,[34] but it should not otherwise affect the application of the general principle behind the provision, namely "to prevent evasion of taxes" and "clearly to reflect... income".[35] To achieve these goals would appear to require some attention to the governing law, whether it be U.S. of foreign.

## IV. THE PRECEDENT OF PRIOR IRS RULINGS

In both of the Private Letter Rulings under discussion, the IRS also relied on the precedent established in two prior Revenue Rulings, the more important of which is Revenue Ruling 76-243.[36] There the IRS held that an allocation was permissible under I.R.C. Section 482 to reflect an appropriate interest charge on an advance charter hire payment made to a foreign subsidiary, despite an agreement with the tax authorities of the foreign country pursuant to which the charter payment was not to be considered as a loan. The Private Letter Rulings contain an excerpt from this previously-published ruling to the effect that

> *any reliance on the holding in* First Security Bank of Utah... *would be misplaced. [The U.S. parent and its foreign subisidiary] ... were not under a legal disability since they could have accepted or rejected the terms of the contract and there was no United States law that prevented receipt of the interest allocated to [the parent] corporation...*[37]

The IRS' reliance on thir prior ruling is itself misplaced, however. The Service attempts to rely on it as support for its position that only legal disabilities under U.S. law can be used to invoke the *First Security Bank of Utah* rule. In point of fact, however, Revenue Ruling 76-243 did not involve a violation of foreign law either. The quotation above clearly indicates that the crux of the ruling is that the taxpayer[38] voluntarily acquiesced in an agreement with the tax authorities. Had it not done so, it might admittedly have been subject in the end to the same type of legal disability as is at issue in these two Private Letter Rulings.[39] But since the Revenue Ruling does not discuss that point, it should only be interpreted as having been based on the voluntary nature of the arrangement. In light of the quotation which the Service itself relies upon in the two Private Letter Rulings, the IRS would appear to take a narrow view of its previous Revenue Ruling.

The second published ruling which the Service discusses is Revenue Ruling 74-245.[40] In that ruling, th IRS permitted a taxpayer to invoke the blocked income accounting method of the Treasury Regulations under I.R.C. Section 482[41] after the taxpayer was advised by legal counsel that the foreign governmental authorities might not allow its foreign subsidiary to make royalty payments for the use of certain registered designs. Although this ruling might be viewed as implying that such blocked income is allocable, there is once again a discernable difference in the factual settings. First, there was no actual prohibition at issue in the Revenue Ruling 74-245, only the opinion of counsel. And the opinion of counsel was to the effect that the foreign government "would not be receptive to allowing" the subsidiary to make the payments and "might consider placing some economic sanctions" on the latter if its parent sought to enforce its license agreement.[42] This would seem to indicate that perhaps no formal legal prohibition existed but rather only a strong policy concern of the foreign government.

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32. I.R.C. Section 61 is the general provision which defines gross income. The IRS has in several cases attempted to allocate income or deductions using this general provision instead of I.R.C. Section 482, ususally without much success however. See, e.g., Rubin v. Comm'r, 429 F.2d 650, 563 (2d Cir. 1970); Richard Rubin, 56 T.C. 1155, 1162 (1971), *aff'd per curiam*, 460 F.2d 1216 (2d Cir. 1972); Philipp Bros. Chems., Inc. (Md.), 52 T.C. 240, 250 n.2 (1969), *aff'd*, 435 F.2d 53 (2d Cir. 1970); Local Fin. Corp., 48 T.C. 773, 789 (1967), *aff'd*, 407 F.2d 629 (7th Cir.), *cert. denied*, 396 U.S. 956 (1969); Grenada Indus., Inc., 17 T.C. 231, 253 (1951), *aff'd*, 202 F.2 873 (5th Cir.), *cert. denied*, 346 U.S. 819 (1953). See generally Levine, "The IRS' Position on Use of Section 482: Recent Cases have Caused Concern", 49 J. TAX. 206 (1978). But see Ogiony v. Comm'r, 80-1 U.S.T.C. ℙ 9265 (2d. Cir. 1980).
33. Olla State Bank of Olla, La. v. U.S., 77-1 U.S.T.C. ℙ 9455 (W.D. La. 1977). But see R.W. Shaw III, 59 T.C. 375, 382 n.4 (1972), *acq.*, 1973-2 C.B. 3 (*First Security Bank of Utah* held inapposite to an assignment of income case under I.R.C. Section 61 when the taxpayer actually received the income).
34. For example, in the case of a transfer or use of intangible property (which is partly at issue in the two Private Letter Rulings under discussion), an arm's length consideration may be determined (in the absence of comparable uncontrolled transactions), after considering a variety of factors -- such as the prevaling rates in the industry, the degree and duration of protection under the governing intellectual property laws, and the availability of substitutes -- any or all of which might vary from a domestic to a foreign context. See Treas. Reg. §1.482-2(d)(2)(iii).
35. I.R.C. §482.
36. See note 13.
37. Rev. Rul. 76-243, see note 13, as quoted in IRS Priv. Ltr. Rul. 7923003, *supra* note 1, and IRS Priv. Ltr. Rul. 8001017, see note 1.
38. Compare U.S. v. Basye, above note 31 (distinguishing a "consensual" arrangement from a legally-imposed disability). See also Aland, above note 11, at 221 n.2. Cf. Prop. Treas. Reg. §1.901-2(a)(2)(ii); Rev. Rul. 76-508, 1976-2 C.B. 225 (denying foreign tax credits in the case of "voluntary" payments to foreign taxing authorities arising from the lack of diligence in pursuing "all effective and practical remedies" to obtain a refund or a reduction of the foreign tax).
39. See Aland, above note 11, at 221.
40. 1974-1 C.B. 124. This Ruling is only discussed in IRS Priv. Ltr. Rul. 8001017, see note 1.
41. Treas. Reg. §1.482-1(d)(6).
42. Rev. Rul. 74-245, see note 40.

The inference one makes is that the payments could perhaps have been made, but that the breach of policy might have led to the imposition of certain *ex post* penalties.

The fact that the Treasury Regulations make a special provision for allocations involving income, the payment of which "was prevented, or would have been prevented, at the time of the transaction because of currency or other restrictions imposed under the laws of any foreign country", [43] is potentially significant but not dispositive of whether such income is allocable by law. In the interpretive ruling governing the application of this Treasury Regulation, the governing term, "deferrable income", is defined as "income received by, credited to the account of, or accrued to a taxpayer that, owing to monetary, exchange or other restrictions imposed by a foreign country, is not readily convertible into United States dollars or into other money or property which is readily convertible into United States dollars". [44] The thrust of the Treasury Regulation therefore seems to be aimed at alleviating not so much the problems of the U.S. taxpayer who can legally receive or the foreign person who can legally pay the income but rather the problems which arise when the income cannot be converted into other currency and exported. In that respect, the Treasury Regulation would appear to fit with the context of the rule established in the seminal case of *Eder v. Commissioner.* [45] In *Eder*, Judges Frankfurter, Augustus Hand and Learned Hand held that a taxpayer could be taxed on blocked foreign income from a foreign personal holding company. The question presented was not whether the taxpayer earned the funds but whether he could be taxed (constitutionally) on the earnings when they were blocked. [46] The answer to the question was yes, although various relief measures have been introduced to alleviate the sometimes harsh results. [47] At stake in the two Private Letter Rulings, however, is whether or not the taxpayers were even able to legally earn the income in the first place.

## V. AN ALTERNATIVE THEORY FOR ALLOCATIONS OF BLOCKED INCOME

According to the Supreme Court, the "purpose of Section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer... ". [48] If that is the case, the IRS should not exercise unbridled authority to allocate income when such income is precluded under foreign law from being accrued, let alone paid to the U.S. taxpayer. Such limitations on payments constitute a factor in determining the arm's length price. In effect, the foreign governmental authorities are determining what they will consider to be an arm's length consideration. Such a determination cannot simply be ignored by the United States. This form of interaction between two tax systems was recognized in the report on transfer pricing recently released by the OECD. [49] There, the OECD Committee on Fiscal Affairs remarked:

> The prices charged for goods, services, etc. transferred between associated enterprises in different countries may be affected by, for example, Government interventions in the form of price control,... or by exchange control or exchange rate policies. *It should be observed that the same considerations would apply to transactions between unrelated enterprises and that they would usually influence the prices in such transactions.*
>
> Of these constraints, exchange controls have given cause for more particular comment. Problems may arise for example because exchange controls effectively prevent an associated enterprise which has received a loan from transferring abroad the interest payments as they fall due, thus possibly throwing doubt on the treatment of the interest for tax purposes. While there may be room for more than one solution in both the country of the borrower (which may or may not regard the untransferred interest as having been paid) and the country of the lender (which may or may not be deemed to have received interest not transferred) it is considered that *there is no justification for treating blocked*

43. Treas. Reg. §1.482-1(d)(6).

44. Rev. Rul. 74-351, 1974-2 C.B. 144. It has been noted that the deferral election of the Treasury Regulations is on its face broader in scope than the terms of this ruling. See Aland, above note 11, at 223 n.17.

45. 138 F.2d 27 (2d Cir. 1943). *Accord* Rodney v. Hoey, 53 F. Supp. 604 (S.D.N.Y. 1944). But cf. International Mortgage & Inv. Corp., 36 B.T.A. 187 (1937) (no realized taxable income to a taxpayer unable to use or convert foreign currency due to exchange controls).

46. In the case of state law restrictions, it is clear that income may be taxed to the party who earns it, regardless of state law, when the income is actually received by the earner. See Ross Glove Co., 60 T.C. 569, 592 (1973); R.W. Shaw III, above note 33, at 382.

47. Compare Treas. Reg. §1.482-1 (d)(6) with I.R.C. §964 (b) and Treas. Reg. §1.964-2 (Subpart F does not apply in the case of blocked income). See also Cheska Cooper, 15 T.C. 757 (1950) (where a taxpayer could convert currency but not export it, the income was taxable but at the lower, free market value of the currency instead of at the official exchange rate).

It has been noted that although the blocked income election may be available to taxpayers facing I.R.C. Section 482 allocations, such an election does not fully cushion adverse tax results. First, the taxpayer will be required to allocate expenses to the blocked income under Treasury Regulation Section 1.482-1 (d)(6) with the consequence of, in effect, a disallowance (really a deferral) of deductions (see Aland, above note 11, at 223). Second, the Service has recently ruled that the election only applies "to a taxpayer's election to adopt the deferred income method of accounting for the first year in which the taxpayer receives (and reports under any accounting method) blocked foreign income". Thus, one may lose the privilege of making such an election for any one taxable year if he has not filed in time. IRS Priv. Ltr. Rul. 7912094, noted in Fuller, "U.S. Private Letter Ruling Report", 80-2 INT'L TAX REP. 1 (Feb. 11, 1980).

Compare Canada's *Income Tax Act* §161 (6), c.63, S.C. 1970-71-72 (giving the Canadian Minister of National Revenue the discretion to defer taxation of blocked income, taking into account the "extreme hardship" of the taxpayer, the inability of the taxpayer to transfer the blocked currency to Canada during the tax year, and the inability to dispose of the income in any manner except to pay any foreign income taxes which may be due). See also Interpretation Bulletin No. IT-351, Nov. 15,1976, reprinted in 5 CAN.TAX REP. (CCH) ¶ 52,356 (1977). See generally TAXES INT'L No. 8, at 17 (April 1980).

48. Commissioner v. First Sec. Bank of Utah N.A., see note 9, 1972-1 C.B. at 136, quoting Treas. Reg. §1.482-1(b)(1). See also Lufkin Foundry & Mach. Co. v. Comm'r, 468 F.2d 805, 1972-2 U.S.T.C. ¶ 9632, at 85,510 (5th Cir. 1972), *rehearing denied per curiam,* 72-2 U.S.T.C. ¶ 9744 (5th Cir. 1972).

49. OECD Committee on Fiscal Affairs, Report on "Transfer Pricing and Multinational Enterprises" (1979).

*payments differently for tax purposes when they occur between associated enterprises from the way in which they would be treated if they occurred between unrelated enterprises.* It is however considered that exchange control regulations in a country should not preclude the deduction for tax purposes, for either associated or unrelated enterprises, of payments due to persons outside that country, although it is recognized that the tax authorities of the other country may have to take the effects of these regulations into account. [50]

The Council of the OECD has adopted a formal recommendation that the Member States' (which includes the U.S.) tax administrations take the Report into account when "adjusting transfer prices between associated enterprises". [51] Thus, the general principle which should govern the IRS position *vis-à-vis* blocked income is that such foreign restrictions should be taken into account in determining the arm's length price. The IRS' own regulations would require no less. They expressly include "any other fact or circumstance which unrelated parties would have been likely to consider" as among those factors to be taken into account when determining the market value which would be charged for intangible property being transferred to an uncontrolled party. [52] And the parties to an uncontrolled transaction would certainly have taken exchange controls into account in their business calculations.

Had the IRS adopted this approach, the result may have been the same although the reasoning would have been different for each of the two Private Letter Rulings. In IRS Private Letter Ruling 7923003, [53] the foreign law set maximum limits on technical assistance fees which were "equally applicable to dealings between related parties and to those between unrelated parties". [54] Thus, the IRS should have taken those limits into account in determining whether an allocation was proper. In effect, the limitations have established the outer parameters of a legal, arm's length compensation in that foreign country. [55] In IRS Private Letter Ruling 8001017, [56] on the other hand, the foreign law prohibiting the payment of royalties is described as restricting such payments only between related parties. This is the case in Peru and other Andean Pact countries, for example. [57] In such cases, the controls are not really aimed at determining an arm's length price but rather at prohibiting the outflow of currency for fear that multinational companies may be trying to "milk" their local subsidiaries. Thus, it cannot be said that such a restriction delimits the arm's length price. Nonetheless, the discussion in the previous section would still be applicable and would preclude an allocation. If foreign law prohibits the payment of such income altogether (as distinguished from the payment of a royalty into a blocked account), the Supreme Court's injunction that "fairness' requires that the tax not fall on a party which cannot receive the income [58] should still be adhered to.

## CONCLUSIONS

Particularly in view of the number of countries which do impose exchange controls of one sort or another, it is disturbing that U.S. taxpayers may be faced with an allocation under I.R.C. Section 482 of income which their foreign subsidiaries may not legally pay to them. As a great majority of the foreign exchange control systems are designed to ascertain whether no more than an arm's length price is being paid to related parties, [59]

50. Idem, at PP 26 & 27, pp. 20-21 (emphasis added).
51. Recommendation of the Council on the Determination of Transfer Prices between Associated Enterprises, Doc. C(79)83 (final), May 16, 1979.
52. Treas. Reg. §1.482-2(d)(2)(iii)(m). See generally Dickey, "A Guide for Pricing Commodities to Enter the Commerce of the United States", 11 L. & POL. INT'L BUS. 491, 538 (1979); Comment, "The Application of Section 482 to the Transfer or Use of Intangible Property", 17 U.C.L.A. L. REV. 202, 218-224 (1969).
53. See note 1.
54. Based on the description of the foreign restrictions, it would appear that the country involved was the Philippines. See PRICE WATERHOUSE INFORMATION GUIDE, CURRENT FOREIGN EXCHANGE INFORMATION 97-98 (1980).
55. The situation is very similar to that in which the taxing authorities of two countries -- neither of which has exchange controls -- have established different standards of judging the arm's length nature of a royalty or other consideration. This is a very common occurrence among the developed countries, each of which has its own range of acceptable royalty rates. Cf. Madere, "International Pricing: Allocation Guidelines and Relief from Double Taxation", 10 TEX. INT'L L. J. 108, 117-118 (1975). In such cases, the two governments may be forced to resort to the competent authority mechanism to divide the allocable income. See generally Liebman, "The Practice and Procedure of Competent Authority: Seeking Relief from Double Taxation Under Bilateral Tax Treaties", 58 TAXES 363 (1980).
56. See note 1.
57. See, e.g., PRICE WATERHOUSE INFORMATION GUIDE, above note 54, at 96.
58. Commissioner v. First Sec. Bank of Utah N.A., above note 9, 1972-1 C.B. at 138.
59. In Spain, for example, royalties or technical assistance fees may be remitted abroad if the Directorate-General of Foreign Transactions (under the Ministry of Commerce) and the Ministry of Industry and Engery have determined that the underlying contract is standard for the industry and does not contain any unfair or abnormal restrictions. See generally J. Russin, E. Vinardell & D. Bralove, "Business Operations in Spain", 273-2nd T.M. at A-30 (1979); WORLD TAX REP. 3 (March 1980). In Greece, the Ministry of Coordination will also undertake a careful analysis of the terms and conditions of any license agreement before approving the payment of royalties to a non-resident. Intercompany charges must also be approved by the Greek Chamber of Commerce. Even if approval is granted, the royalty payment may not be exported unless a license is granted by the Bank of Greece. See generally G. Stathopoulos, "Business Operations in Greece", 194-3rd T.M. at A-50-A-51 (1979). A similar review by the Foreign Investment Institute and Central Bank takes place in Portugal. See PRICE WATERHOUSE INVESTMENT GUIDE, above note 54, at 100.
Outside of Europe, such controls are even more prevalent. In Latin America, mention might be made, in particular of Argentina, Brazil, and Colombia (see idem, at 4-5, 22, 30), in all of which agreements for technology or know-how transfers must be submitted to special bodies for approvals which, in large part, depend upon an analysis of the necessity or social value of the know-how or technical assistance and the terms and conditions of the contract. See, e.g., D. Perenzin, "Business Operations in Colombia", 260-3rd T.M. at A-2 - A-3 (1978). In Africa, Nigeria has a relatively strict exchange control system, as does Malawi. See PRICE WATERHOUSE INFORMATION GUDIE, above note 54, at 72-73, 86; Alegi, "Nigeria: A Legal and Tax Primer for the U.S. Investor", 78-10 TAX MANAGEMENT INT'L J. 11, 17-18 (Oct. 1978).

the IRS should take greater cognizance of such restrictions and should not be exercising its reallocation authority in such cases.

Unfortunately, U.S. taxpayers will continue to find themselves in a bind until these letter rulings are either revoked or superseded or the issue is resolved in court. The argument that foreign tax law should have precluded an IRS allocation was raised in a recent I.R.C. Section 482 case, but the court decided in the taxpayer's favor without having to reach this issue.[60] Reportedly, the issue has been squarely raised in another case presently before the Court of Claims.[61] Until that case is decided, taxpayers can expect these two Private Letter Rulings to be followed, regardless of their lack of a solid foundation.[62]

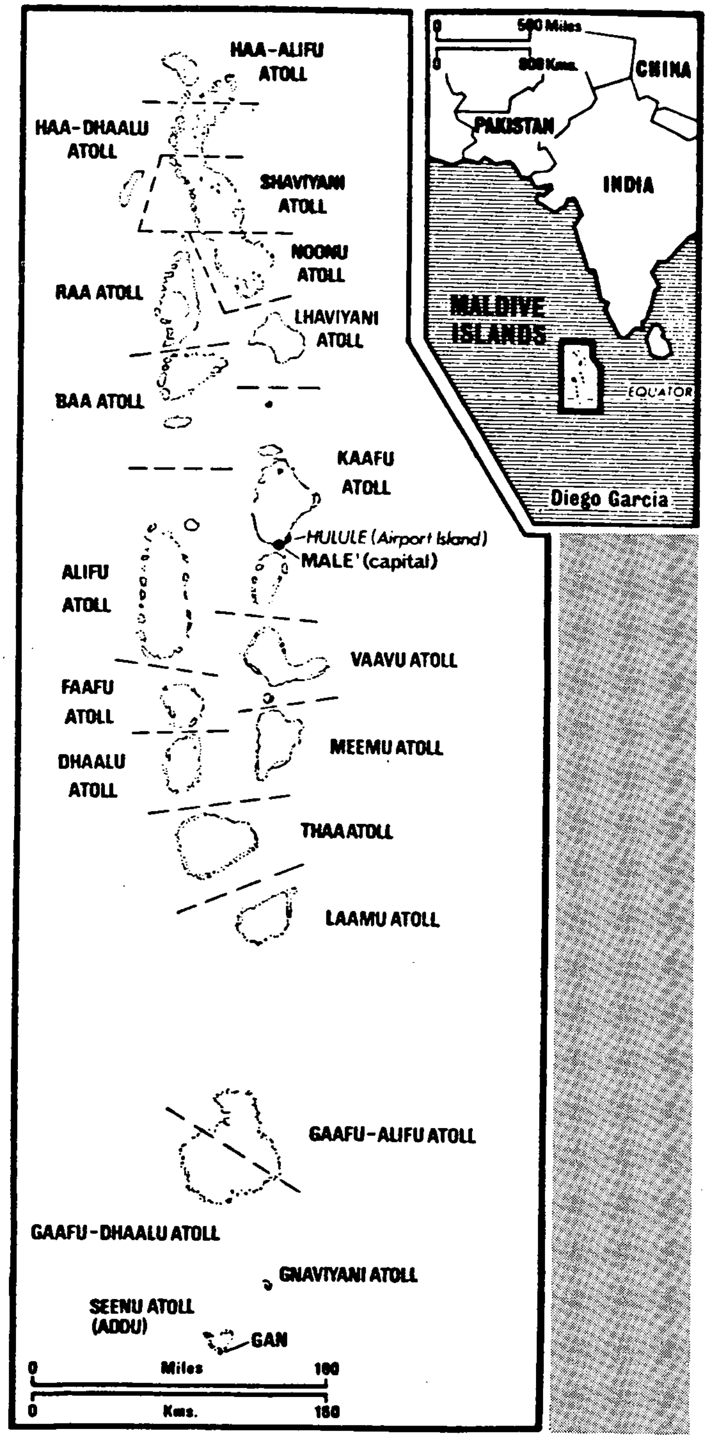
60. See U.S. Steel Corp. v. Comm'r, 80-1 U.S.T.C. ¶ 9307, at 83,704 n. 12 (2d Cir. 1980), *rev'g* 36 T.C.M. 586, 603 (1977).
61. Trans-Arabian Pipe Line Co., Dkt. No. 561-78 (Ct. Cl.). See the discussion in Aland, above note 9, at 221-222.
62. In a recent decision by the Second Circuit Court of Appeals, Judge Oakes commented that although the IRS does not allow taxpayers to rely upon private rulings as precedent, it relies on them itself in order to determine the tax treatment to accord to similarly situated taxpayers. See Ogiony v. Comm'r, above note 32, at 83,525 (2d Cir. 1980) (Oakes, J. concurring), noted in [1980] 10 STAND. FED. TAX REP. (CCH) ¶ 8258.

# Maldives: Foreign Investment Law

by Dr. M.P. Dominic

*Maldives consists of 1,196 islands in the Indian Ocean to the Southwest of India and Sri Lanka, stretching nearly 500 miles in length and 80 miles in width. They lie from 7 degrees north to 1 degree south of the equator. The land area is only 115 square miles. However, the territorial boundaries have been extended to 200 miles and hence the sea area is considerable. The capital is Male. The population of 143,469 (per 1978 census) is 100 percent muslim (sunni sect). The language is Divehi.*

*The exchange rate of the Maldivian rupee for official transactions is 3.93 for US$1; for unofficial transactions, the exchange rate is 8.80 Maldivian rupees for US$1.*




Foreign investments in Maldives are governed by Law No. 25/79. The law came into force from 1 May 1979. For foreign investment in tourist resorts and tourist hotels, Law No. 15/79 applies.

Foreign investment is welcome. Preference is given to investments which satisfy the following:

- it provides employment for the locals;
- it contributes to the economic and social infrastructure of the country;
- it could not have been made by local investors because of the size of the investment required or due to the lack of technical expertise;
- it is to be located in the outer atolls rather than in the vicinity of Male;
- the product of the proposed investment is locally marketable at competitive prices and thereby the import of such products is reduced;
- it utilizes local materials;
- it trains local employees with the aim of employing them at technical, skilled and management level.

Application for investment must be made in the prescribed form to the Department of Tourism and Foreign Investment together with the following:

- a comprehensive feasibility report;
- draft copy of the Memorandum and Articles of Association;
- a recognized bank reference;
- the draft agreement between the foreign investor and Maldivian investors;
- a covering letter; and
- other information relevant to the proposed venture

such as the terms and conditions of foreign participation.

The proposed capital of the investment must be clearly stated in a convertible currency acceptable to the Department.

The Department of Tourism and Foreign Investment will appraise the investment project in consultation with other concerned Departments and Ministries of the Government.

The decision to approve or reject the proposal will be made and notified to the applicant as soon as possible; the length of time will depend largely on the completeness and adequacy of the supporting data.

Once the approval is granted, a licence will be issued in the name of the applicant. In general, the project must be implemented within six months from the date of issue of the licence. However, the period of time for the implementation of the project may be varied and specified in the licence, if the circumstances warrant it. Under certain circumstances, the Government may, before issuing the licence, issue a letter of intent so that the prospective investor is assured of the licence after he has incurred expenses of making feasibility and technical studies.

The prospective investor must register his company, within seven days of the issuance of the licence, with the Ministry of Home Affairs, Male. Further, prior to the commencement of the investment project, one fourth of the approved capital must be deposited with a local bank agreeable to the Department of Tourism and Foreign Investment. In addition, the investor must sign an agreement with the Department of Tourism and Foreign Investments.

Guarantee is given against the closure of the investment during the agreement period, except where the investor is engaged in an activity detrimental to the security of the country. The draft agreement provides for a period of five years, but this is renewable.

Remittance of profits in accordance with the terms of the agreement and repatriation of the liquidation proceeds in the event of the closure of the investment (voluntary or compulsory) are guaranteed.

The following incentives are granted:

- exemption from duty on import of machinery, equipment, raw materials and any other articles of daily necessity for the use of the investor or his foreign employees, for a period of eight years;
- exemption of the investor and foreign employees from all corporate tax, income tax and any local taxes for a period of seven years (for local investment, the tax holiday period is limited to five years); however, it must be noted that at present no taxes other than tourism tax and the bed night tax are levied in Maldives;
- exemption from export duty for a period of ten years;
- guarantee for repatriation of profits and capital;
- guarantee against closure of the investment by the Government during the period of the agreement.

Any dispute arising between the Government and the foreign investor will be referred to the Maldivian Court of Law for adjudication; the decision of the court is final and conclusive.

Books of accounts must be maintained in such a manner that expenditure and revenue can be determined therefrom independently. The accounts may be maintained in Maldivian rupees, U.S. dollars or in any foreign currency acceptable to the Department of Tourism and Foreign Investment. The books and the supporting documents must be maintained in Divehi or in English and they must not be destroyed without prior permission of the Department. The Department of Tourism and Foreign Investment may require the investor to submit, for auditing purposes, the books of accounts and supporting documents to the authorised officials. At the end of each financial year or, failing this, every calendar year, the balance sheets and profits and loss statements must be prepared.

Law No. 15/79 applies to investments in tourist resorts and tourist hotels. Tourist resort means an island or a special area of an island where board and lodging facilities are generally provided for tourists. Tourists hotel means a place in an inhabited island where board and lodging facilities are generally provided for tourists. Under this law, tourist resorts and tourist hotels in Maldives must be registered at the Department of Tourism and Foreign Investment. The number of beds in such resorts or hotels must also be registered. Any change in the number of registered beds in a tourist resort or a tourist hotel may be made only after the Department of Tourism and Foreign Investment is duly notified and the change duly registered. Where the owner of such resort or hotel wishes to entrust the management to another party, either by a lease or on any other basis, an application must first be made to the Maldivian Government. The management may be entrusted to such other party only if the Maldivian Government declines to accept the management of the resort or hotel. When approval is obtained, the management must be entrusted to the other party through the Department of Tourism and Foreign Investment. No tourist resort or tourist hotel shall be taken over by the Government without giving at least two years' notice, except where it is required for the country's defence.

Private owners of tourist resorts and tourist hotels will be subject to

- a tourism tax of US$3.00 per registered bed per day, after 2 years of operation; and
- a bed night tax of US$1.00 per registered bed per day.

However, the imposition of these taxes on the number of beds varies according to the tourist season. For November through January, these taxes will be imposed on 80 percent of the registered beds and must be paid before 15 February. For February through April, these taxes will be imposed on 60 percent of the registered beds and shall be paid before 15 May. The taxes for May through October will be on 20 percent of the registered beds; the taxes for May, June and July must be paid before 15 August and the taxes for August, September and October must be paid before 15 November.

# UNITED STATES

# TERRITORIAL INCOME TAX SYSTEMS

## *Income taxation in the Virgin Islands, Guam, the Northern Mariana Islands and American Samoa (A U.S. Treasury Report)*

### I. INTRODUCTION AND SUMMARY

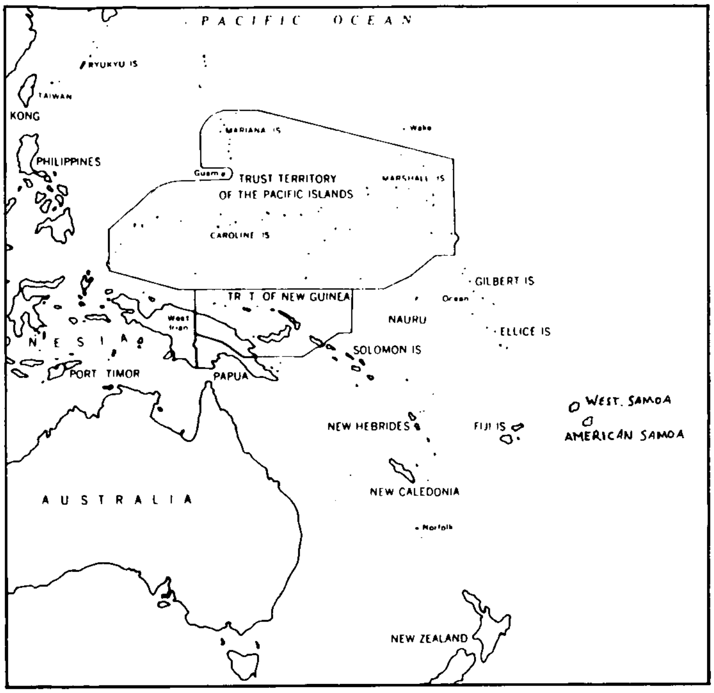
This Report examines the income tax systems of the Virgin Islands, Guam, the Northern Mariana Islands and American Samoa. The U.S. Treasury has two interests in the workings of these income tax systems. The first and more historical is that these systems bear a special relationship to the Federal income tax. Not only do the territorial tax codes "mirror" the Federal code, but U.S. citizens who are inhabitants of the Virgin Islands, Guam, or the Northern Mariana Islands are relieved of the obligation of filing a Federal return and paying Federal taxes by doing so in the territory. No other tax jurisdictions in the world are accorded this status. This special status, together with the industrial incentive programs which provide for a rebate of territorial income taxes, has created for the U.S. Treasury and Internal Revenue Service an unending series of technical problems which cannot be resolved satisfactorily under existing statutory authority.

More recently, the Administration has been concerned with the slow growth of the private economic sector in the territories, the growing fiscal problems of the territorial governments and their increasing dependence on the Federal government for financial support. Because the dollar value of the territories' income tax collections, despite inflation, has increased only slightly over the last five years, the territorial income tax systems appear to be failing to fulfill their basic, revenue-raising objective.

The Administration's concern for the territories' economic development, financial problems, and political status is reflected in a separate series of Interagency Task Force Reports and, accordingly, will not be addressed in any detail here. This Report has a narrower, more technical objective. It seeks to evaluate the territorial income tax systems in terms of their ability to raise revenues in a straightforward and equitable fashion. Section II reviews the essential features of the Federal income tax laws, which, under the "mirror" systems, are the basis of the territorial income tax systems. Section III describes the operation of each territory's mirror system and the problems of coordination with the Federal income tax system. Section IV evaluates the territorial tax systems in terms of raising revenue, equitable treatment of territorial versus stateside residents, and simplicity of compliance and administration.

The Report concludes that the territorial income tax systems are functioning poorly and should be overhauled. Specific proposals for reform are being considered by the Administration in light of overall Federal policy toward the territories and will be advanced shortly.

**Contents**




## Summary

In general, territorial residents and corporations operating in the territories file returns and pay taxes to the territory which they inhabit and, by doing so, are relieved of such obligations to the Federal government. Each territory is a separate tax jurisdiction administering income tax laws which are identical to those in force in the United States. To give the Federal code its proper effect in each territory, the words "Virgin Islands", "Guam", "Northern Mariana Islands" or "American Samoa" are substituted for the words "United States" where appropriate in the Federal Internal Revenue Code. This results in what have come to be known as the "mirror" codes. Together with various special provisions differing from territory to territory, but all relating to the coordination of Federal and territorial income taxation, the "mirror" codes govern the system of income taxation in each U.S. territory.

The "mirror" systems are, at least in principle, well suited to meeting three objectives. First and foremost, they provide the territories with local tax revenues for meeting a part of their government expenditures. Second, they subject territorial and mainland residents to comparable income tax burdens. Third, they may simplify income tax administration by providing the territories with a tax code, regulations, tax forms and a judicial system.

Although having the territories mirror the Federal income tax system seems well suited to these three objectives, in actual practice the results have been disappointing. The most obvious disappointment has been in the amount of income tax revenues collected by the territories.

In the Virgin Islands and Guam, income tax revenues as a percentage of gross territorial product fell by more than one third in the period 1973 through 1978. The reports of the Federal comptrollers for the territories and the recently released GAO report on Guamanian tax administration[1] suggest substantial deficiencies in procedures for collecting taxes due. The territories have attributed this drop in income tax collections to recent changes in the Federal income tax (such as the increase in the standard deduction) which were automatically mirrored in the territorial tax codes. As demonstrated below, however, the loss of territorial tax revenues must be attributed to other factors.

The mirror systems have also failed to ensure that territorial and mainland residents are subject to comparable income tax burdens. In all territories, the poor records of administration and compliance have widened the gap between the law and actual practice. Moreover, the substance of the territorial income tax laws produces inequities in the tax treatment of mainland residents vis-à-vis residents of the territories. Under the Virgin Islands mirror system, mainland residents who derive income from the Virgin Islands are eligible for fewer deductions and subject to possibly higher tax rates than they would be if they were V.I. residents. Under the Marianas mirror system, 100 percent of the tax on Marianas-source income is rebated to Marianas residents. Under the Guamanian mirror system, 75 percent of the tax paid to Guam on foreign earned income may be rebated to Guamanian residents. In addition to reducing equity, these rebate provisions undermine Federal tax administration by encouraging U.S. citizens to establish (or claim to have established) residence in the territories in order to avoid having to file a Federal return, pay Federal taxes, and be subject to Federal audit.


1. Report by the Comptroller General of the United States, "The Government of Guam's Administration of Its Income Tax Program", GGD-80-3, October 3, 1979.

Although basing the territorial income tax systems on the Federal tax laws has the advantage of giving the territories a ready-made income tax together with published regulations, tax forms, and a judicial system, the need to mesh the Federal and territorial tax jurisdictions has given rise to numerous problems. Because the laws governing the coordination of the Federal and territorial tax systems are in many cases conflicting or ambiguous, these questions cannot be resolved satisfactorily under existing statutory authority. For example, section 935 of the Internal Revenue Code provides that Guamanian residents are free of Federal income tax liability. Another section of the Code permits the United States to withhold Federal taxes on pensions paid to retirees resident on Guam. The provisions by which such withholding taxes were paid over to the Guamanian treasury were apparently repealed in 1972. These and other inconsistencies are continual irritants in U.S.-territorial relations.

A final problem with the territorial tax systems is that they provide an inefficient and costly system of tax incentives for territorial investment. In general, current law permits corporations to operate in the territories free of Federal income tax on their territorial source income, while it permits the territories to enact companion tax-incentive programs. The rationale of the current Federal law is to promote the economic development of the territories, but the law does not relate the Federal tax foregone to the benefits received by the territories. The relief from Federal tax and the rebate of territorial tax on territorial source income encourages profit-sharing to the territories, and generates numerous and severe transfer-pricing problems for the Internal Revenue Service. In one case, the tax relief granted by territorial law and then "preserved" by Federal law represented almost $60,000 for every Virgin Islands employee.

## II. FEDERAL INCOME TAXATION OF INDIVIDUALS AND CORPORATIONS

### A. U.S. citizens, residents and corporations

To understand the systems of income taxation in the Virgin Islands, Guam, the Northern Mariana Islands, and American Samoa, one must first understand certain essentials of the Federal system of taxation of individuals and corporations. U.S. citizens,[2] non-U.S. citizens who are resident in the United States, and corporations organized under the law of the United States or of any State are all taxed on their *worldwide* gross income less allowable deductions. Corporations are taxed on income of unincorporated branches operating abroad as well as at home, and on dividends,[3] interest and other income received from domestic and foreign subsidiaries. U.S. corporations are not subject to Federal tax on earnings retained by a foreign subsidiary unless such income has certain "tax haven" characteristics as defined under the Internal Revenue Code.

In general, deductions are allowed for all ordinary and necessary expenses of earning income. Individuals may either itemize deductions or claim the standard deduction (zero-bracket amount).[4] Individuals may also exempt $1,000 of income for themselves, for each qualifying dependent, and on account of age or blindness. U.S. citizens who are resident in a foreign country may deduct "excess" housing and other living costs, costs of dependents' education, and home-leave transportation.[5]

Net income is taxed at progressive rates: the maximum rate for individuals is 70 percent; for corporations, the top rate is 46 percent. Married individuals filing jointly and unmarried individuals pay a maximum rate of 50 percent on wages, salaries and other personal service income. The total tax liability can be offset by various tax credits, such as the investment tax credit and the foreign tax credit. The investment tax credit generally equals 10 percent of the value of equipment and other qualifying assets "placed in service" in the United States; the credit is not available for assets placed in service outside the United States.[6] The foreign tax credit is a dollar-for-dollar credit available for income taxes paid to foreign governments. However, to prevent the foreign tax credit from offsetting U.S. tax on domestic income, the amount of credit is limited to the U.S. tax liability on foreign source income.

### B. Nonresident aliens and foreign corporations

Under some circumstances, a foreign individual will pay a higher U.S. tax if he is not considered a resident of the United States; in other circumstances, his U.S. tax will be lower. Accordingly, the criteria for determining residence are important in determining the U.S. tax liability of a non-U.S. citizen. Regulations issued under the Internal Revenue Code provide standards for the determination of residence:

"An alien actually present in the United States who is not a mere transient or sojourner is a resident of the

2. Although persons born or naturalized in the Virgin Islands and Guam are U.S. citizens, for convenience of exposition references in this paper to "U.S. citizens" will mean only individuals born or naturalized within the fifty States and the District of Columbia. The source of this distinction is the Internal Revenue Code, sections 932 and 935, and the Revised Organic Act of the Virgin Islands, section 28(a). Persons born or naturalized in the Northern Mariana Islands will become U.S. citizens upon the termination of the Trusteeship Agreement, expected in 1981.

3. Affiliated corporations that do not file consolidated returns are allowed to deduct from their income 100 percent of "qualifying dividends" received from members of the affiliated group. Only U.S. corporations may qualify as members of an affiliated group for purposes of the dividends-received deduction.

4. The zero-bracket amount is $3,400 for married individuals filing jointly, $1,700 for married individuals filing separately, and $2,300 for unmarried individuals.

5. Taxpayers who must live in construction, mining or other "camps" may exclude $20,000 of income earned abroad in lieu of taking the otherwise applicable deductions for excess living costs.

6. An exception to this rule is made for assets placed in service in a U.S. territory, provided that the taxpayer does not receive the tax relief benefits of section 931, 932, 933, 934, or 936. (U.S. Income Tax Regulations section 1.48-1(g)(vii)).

United States for purposes of the income tax. Whether he is a transient is determined by his intentions with regard to the length and nature of his stay. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute him a transient. If he lives in the United States and has no definite intention as to his stay, he is a resident. One who comes to the United States for a definite purpose which in its nature may be promptly accomplished is a transient; but, if his purpose is of such a nature that an extended stay may be necessary for its accomplishment, and to that end the alien makes his home temporarily in the United States, he becomes a resident, though it may be his intention at all times to return to his domicile abroad when the purpose for which he came has been consummated or abandoned. An alien whose stay in the United States is limited to a definite period by the immigration laws is not a resident of the United States within the meaning of this section, in the absence of exceptional circumstances."[7]

The intention of an individual is usually inferred from the terms of his visa for entering the United States, the length of his stay, his ownership of a home or the terms of an apartment or office lease.

A foreign national who is not a resident of the United States (a nonresident alien) or a foreign corporation may have three types of income for U.S. tax purposes:

1. Income effectively connected with a U.S. trade or business. Such income can be *offset by deductions* and is taxed *according to the same general rules* as those applicable to income earned by U.S. residents and domestic corporations. This category includes an individual's wages, salary or other remuneration for personal services performed within the United States, and profits attributable to a U.S. plant or office of a foreign corporation.

2. Interest, dividends, rents and other "fixed and determinable, annual or periodic" income (plus certain other types of income) which are U.S.-source, but not effectively connected with a U.S. trade or business. This income *cannot be offset by deductions* and is taxed *at a flat rate of 30 percent* (or less if covered by a tax treaty with a foreign country).

3. All other income (including some U.S.-source income) which is *exempt from U.S. taxation.*

Although effectively connected income is generally taxed as if it has been earned by a U.S. resident or domestic corporation, some differences do occur in the tax treatment of a nonresident alien or foreign corporation with respect to such income:

— A nonresident alien's or foreign corporation's losses effectively connected with a U.S. trade or business cannot be used to offset U.S.-source interest, dividends, and other income not effectively connected with a U.S. trade or business.

— A nonresident alien can claim only one personal exemption. Additional exemptions cannot be claimed for dependents or on account of the individual's age or blindness.

— A nonresident alien must itemize deductions — that is, he cannot claim the zero-bracket amount. Apart from charitable contributions, deductions are generally limited to those allocable to income effectively connected with the U.S. trade or business.

— A nonresident alien generally cannot file a joint return with his spouse.[8] Not only will he be subject to the harsher limitations and schedules applicable to married individuals filing separate returns, but he cannot limit his tax on personal services income (wages and salary, etc.) to the otherwise applicable maximum rate of 50 percent.

— A nonresident alien may not elect, nor join with others in electing, to have a U.S. corporation in which he is a shareholder taxed according to the rules of Subchapter S. The Subchapter S rules allow a U.S. corporation with 15 or fewer shareholders to elect not to pay tax provided its shareholders include a proportionate share of the corporation's income or loss in their income.

## C. Recent changes in Federal income taxation

Taxation of individuals and corporations was changed significantly by the Tax Reduction Act of 1975, the Tax Reform Act of 1976, the Tax Reduction and Simplification Act of 1977, and the Revenue Act of 1978. The overall thrust of the changes in the taxation of individuals was to offset the impact of inflation on effective tax rates, defined as the ratio of personal taxes to income.

With a progressive tax structure, increases in nominal income that move a taxpayer into a different rate bracket can dramatically increase his tax burden. Furthermore, with exemptions and deductions stated in fixed dollar terms, taxable income during a period of high inflation rises more rapidly than the inflation. Real income — the taxpayer's actual purchasing power — may stay the same or actually decline, but his tax liability increases in real terms as a result of the inflation of his income.

Table 1 on the following page shows the impact on real income tax liabilities of the 50 percent inflation of the dollar in the period 1972 to 1979. This table expresses all amounts in 1979 dollars, and assumes that the real incomes of taxpayers stayed the same in this period. The 1972 income tax in column 2 is calculated by applying the 1972 tax laws to the various income levels translated into 1972 dollars; the hypothetical 1979 income tax in column 4 is calculated by applying the 1972 tax laws to the various income levels translated into 1979 dollars. Comparison of columns 2 and 4 shows that, in the absence of changes in the Federal tax laws, inflation would have increased the effective tax rate for individuals in the lowest income levels by at

7. Income Tax Regulations section 1.871-2(b).

8. If a nonresident alien is married to a U.S. citizen or resident, the nonresident alien may elect to join his or her spouse in filing a joint return. If this election is made, the nonresident alien individual is treated as a resident for U.S. tax purposes, and thus the married couple is taxable on its combined worldwide income.

least 100 percent. At higher income levels, the effective tax rate for individuals would have risen between roughly 15 and 50 percent in the period 1972 to 1979.

**TABLE 1**

**Impact of inflation on income tax burdens in 1979, assuming 1972 tax law (1979 dollars)**

*Single returns*

| *1979 Levels of wage income* [1] | *1972 Income tax* | | *Hypothetical 1979 Income tax* | |
|---|---|---|---|---|
| | *Amount* | *Effective tax rate* | *Amount* | *Effective tax rate* |
| 2,500 | 0 | 0 | n.a. | n.a. |
| 5,000 | 216 | 4.3 | 509 | 10.2 |
| 7,500 | 640 | 8.5 | 1,006 | 13.4 |
| 10,000 | 1,000 | 11.0 | 1,448 | 14.5 |
| 12,500 | 1,496 | 12.0 | 1,807 | 14.5 |
| 15,000 | 1,900 | 12.7 | 2,341 | 15.6 |
| 20,000 | 2,829 | 14.1 | 3,461 | 17.3 |
| 25,000 | 3,809 | 15.2 | 4,738 | 19.0 |
| 30,000 | 4,875 | 16.3 | 6,179 | 20.6 |
| 40,000 | 7,285 | 18.2 | 9,460 | 23.7 |
| 50,000 | 10,092 | 20.2 | 13,214 | 26.4 |
| 100,000 | 28,100 | 28.1 | 32,463 | 32.5 |

*Joint returns with two dependents*

| *1979 Levels of wage income* [1] | *1972 Income tax* | | *Hypothetical 1979 Income tax* | |
|---|---|---|---|---|
| | *Amount* | *Effective tax rate* | *Amount* | *Effective tax rate* |
| 2,500 | 0 | 0 | n.a. | n.a. |
| 5,000 | 0 | 0 | n.a. | n.a. |
| 7,500 | 21 | 0.3 | 255 | 3.4 |
| 10,000 | 369 | 3.7 | 982 | 9.8 |
| 12,500 | 668 | 5.3 | 1,391 | 11.1 |
| 15,000 | 989 | 6.6 | 1,619 | 10.8 |
| 20,000 | 1,713 | 8.6 | 2,414 | 12.1 |
| 25,000 | 2,458 | 9.8 | 3,384 | 13.5 |
| 30,000 | 3,305 | 11.0 | 4,468 | 14.9 |
| 40,000 | 5,153 | 12.9 | 7,083 | 17.7 |
| 50,000 | 7,259 | 14.5 | 10,184 | 20.4 |
| 100,000 | 22,433 | 22.4 | 29,114 | 29.1 |

Office of the Secretary of the Treasury
Office of Tax Analysis — June 17, 1979

*Note:* Deductible expenses assumed to equal 23 percent of gross income.

1 Equivalent 1972 and 1979 real incomes are derived from the consumer price index: 1972 = 125.3; 1979 (estimated) = 214.15

What the changes in the tax law after 1972 did was to offset the tendency of inflation to subject taxpayers to higher tax rates. The general tax credit of $35 for each taxpayer and dependent (regardless of income), the earned-income credit for low-income individuals (a credit which is refunded to the individual if it exceeds his pre-credit tax liability), increases in the amount of the standard deduction,[9] and, in 1975 only, a rebate of 10 percent of the previous year's taxes up to a limit of $200, were all of particular benefit to low-income individuals. The Revenue Act of 1978 focused its tax reductions on middle-to-upper income taxpayers (who, in turn, were hardest hit by the increased Social Security tax). This Act reduced statutory tax rates, widened tax brackets, and increased the personal exemption from $750 to $1,000 per taxpayer and dependent.

Table 2 compares the impact on effective tax rates of the tax law changes and of inflation. Like Table 1, it expresses all amounts in 1979 dollars. Table 2 shows that for income levels below $15,000, the changes in the tax laws offset roughly 85 percent of the increase in tax liabilities caused by inflation. For income levels of $15,000 or more, the changes in the tax laws offset from 66 percent to 15 percent of the increase in tax liabilities due to inflation, with the lower percentages applicable to the higher income levels. Otherwise stated, effective rates were allowed to rise by between 2 and 5 percent of income at the middle and upper income levels.[10]

A critical implication of Table 2 is that despite the substantial tax reductions made by the 1975, 1976, 1977, and 1978 revenue acts (whose cumulative impact is shown in column 2 of Table 2), the ratio of personal taxes to earned income tended slightly to increase for most real income classes. This point will be developed in Section IV below. It has important implications for the validity of the territories' claims for Federal reimbursement for revenue losses incurred as a result of changes in the Federal income tax.

## III. TERRITORIAL INCOME TAXATION AND THE RELATIONSHIP TO FEDERAL TAXATION

### A. Virgin Islands

#### 1. Basic tax system

"The income tax laws in force in the United States of America and those which may hereafter be enacted shall be held to the likewise in force in the Virgin Islands, except that the proceeds of such taxes shall be paid into the treasuries of said islands."

With this section of the Naval Appropriations Act of 1922, Congress provided for an income tax in the Virgin Islands. Court interpretations have indicated that this provision created an income tax jurisdiction distinct from that of the United States. The Internal Revenue Code defines the United States to include only the fifty States and the District of Columbia, and defines "domestic" when applied to a corporation to mean organized in the United States. Since the Virgin Islands mirror system substitutes the words "Virgin Islands" for the words "United States" where appropriate, United States residents and corporations are treated as

9. Because middle-to-upper income taxpayers tend to itemize deductions, increases in the standard deduction tend to be of less benefit to them.

10. The increase in 1979 effective tax rates at the upper income levels will in future years be partly offset by the more liberal tax treatment of capital gains provided by the Revenue Act of 1978.

nonresident aliens and foreign corporations for purposes of Virgin Islands income taxation.

Because the Internal Revenue Code subjects nonresidents aliens to different rules than residents, the Virgin Islands mirror system may result in inequities in the taxation of U.S. persons who derive income from the territory. Some of the specific consequences of the V.I. mirror system for a resident of the United States are that:

— His Virgin Islands "not effectively connected" income is taxed at a flat 30 percent rate on a gross basis;

— He is not allowed to take deductions except to the extent that they are related to income effectively connected with the Virgin Islands trade or business;

— He may take only one personal exemption;

— He is not entitled to file a joint return unless his spouse is a Virgin Island resident; if he is unmarried, he may not use the "head of household" rate schedule.

Although a U.S. resident can claim a foreign tax credit against his Federal tax liability for taxes paid to the Virgin Islands, the above provisions of the Virgin Islands Code could compel a tax in excess of the Federal foreign tax credit limitation.

While the Virgin Islands tax administration and the Internal Revenue Service uphold the mirror system, as described above, two recent court decisions[11] have questioned the validity of the treatment of U.S. persons as foreign for purposes of Virgin Islands taxation. In *Chicago Bridge*,[12] the Third Circuit stated that it would be *contrary* to its understanding of Congress' intent to compel a U.S. taxpayer to pay a higher tax to the Virgin Islands than he would be required to pay on the same income to the United States:

> "The scheme of the statute (the Naval Appropriations Act of 1922) is to impose a tax obligation to the Virgin Islands equivalent to what the United States would collect on the same income, but for the mirror system ... More basically, Congress has aided the Virgin Islands by giving them the same tax, not more, than the United States would otherwise collect on Virgin Islands business."

Administering the territorial tax in order to achieve the result of equivalency would require the law to be changed to treat U.S. citizens, residents, and corporations as domestic, not foreign. It means applying the territorial income tax as if the territory included the United States.

A second basic feature of the Federal law government income taxation in the Virgin Islands is that individuals and corporations which are "inhabitants of the Virgin Islands" satisfy their Federal tax liability by filing a Virgin Islands tax return and paying Virgin Islands tax. The Revised Organic Act of 1954, section 28(a), provides that:

> "the term 'inhabitantsof the Virgin Islands' as used in this section shall include all persons whose permanent residence is in the Virgin Islands, and such persons shall satisfy their income tax obligations under applicable taxing statutes of the United States by

**TABLE 2**

**Cumulative change in tax liabilities, 1972-1979**
**(1979 dollars)**

*Single returns*

| *1979 Levels of wage income* 1 | *Change due to change in law* 2 | *Change due to inflation* | *Total change* | |
|---|---|---|---|---|
| | | | *In amount* | *In effective tax rate* |
| 2,500 | 0 | 0 | 0 | 0 |
| 5,000 | –259 | 293 | 34 | 0.7 |
| 7,500 | –313 | 366 | 53 | 0.7 |
| 10,000 | –272 | 348 | 76 | 0.8 |
| 12,500 | –222 | 311 | 89 | 0.7 |
| 15,000 | –293 | 441 | 148 | 1.0 |
| 20,000 | –345 | 632 | 287 | 1.4 |
| 25,000 | –374 | 929 | 555 | 2.2 |
| 30,000 | –460 | 1,304 | 844 | 2.8 |
| 40,000 | –574 | 2,175 | 1,601 | 4.0 |
| 50,000 | –654 | 3,122 | 2,468 | 4.9 |
| 100,000 | –671 | 4,363 | 3,692 | 3.7 |

*Joint returns with two dependents*

| *1979 Levels of wage income* 1 | *Change due to change in law* 2 | *Change due in inflation* | *Total change* | |
|---|---|---|---|---|
| | | | *In amount* | *In effective tax rate* |
| 2,500 | 0 | 0 | 0 | 0 |
| 5,000 | 0 | 0 | 0 | 0 |
| 7,500 | –255 | 234 | –21 | –0.3 |
| 10,000 | –608 | 613 | 5 | 0.1 |
| 12,500 | –599 | 723 | 124 | 1.0 |
| 15,000 | –385 | 630 | 245 | 1.6 |
| 20,000 | –401 | 701 | 300 | 1.5 |
| 25,000 | –483 | 926 | 443 | 1.8 |
| 30,000 | –549 | 1,163 | 614 | 2.0 |
| 40,000 | –770 | 1,930 | 1,160 | 2.9 |
| 50,000 | –861 | 2,925 | 2,064 | 4.1 |
| 100,000 | –1,236 | 6,681 | 5,445 | 5.4 |

Office of the Secretary of the Treasury
Office of Tax Analysis — June 17, 1979

*Note:* Deductible expenses assumed to equal 23 percent of gross income.

1 Equivalent real incomes are derived from the consumer price index: 1972 = 125.3; 1973 = 133.1; 1974 = 147.7; 1975 = 161.2; 1976 = 170.5; 1977 = 181.5; 1978 = 195.4; 1979 (estimated) = 214.15.

2 The refundable portion of the earned income credit is not included.

11. *Chicago Bridge and Iron Co. v. Wheatley*, 430 F. 2d 973 (3rd Cir. 1970) and *Vitco, Inc. v. Govt. of V.I.*, 560 F. 2d 180 (3rd Cir. 1977). The *Vitco* case is discussed below.

12. The issue in *Chicago Bridge* was whether a U.S. corporation was entitled to use the Western Hemisphere Trade Corporation deduction to reduce its income tax liability to the Virgin Islands. The District Court denied the deduction on grounds that the U.S. corporation was a foreign corporation for purposes of Virgin Islands income taxation. Reversing the lower court decision, the Third Circuit held that "substantive equality of treatment in determining deduction under V.I. mirror system of taxation requires the term 'domestic' to be given the same meaning under V.I. Code as under [the Federal Internal Revenue Code]." Accordingly, the Third Circuit held that the U.S. corporation was entitled to use the WHTC deduction to reduce its Virgin Islands income tax liability.
At the request of the Virgin Islands, Congress provided that for tax years beginning in 1972, neither U.S. nor V.I. corporations are permitted the WHTC deduction in computing their Virgin Islands income tax liability. (Revenue Act of 1971, P.L. 92-178, section 307).

paying their tax on income derived from all sources both within and outside the Virgin Islands into the Treasury of the Virgin Islands."

Thus, a resident of the Virgin Islands or a corporation deemed to be a V.I. inhabitant does not file a U.S. income tax return or pay tax to the Federal government. However, all other U.S. citizens, residents and corporations which derive income from the Virgin Islands file two tax returns and receive a foreign tax credit to offset their U.S. tax liability with respect to income derived from or effectively connected with the Virgin Islands.

Section 28(a) of the Revised Organic Act has made the Virgin Islands attractive to U.S. corporations seeking to avoid taxation. In the absence of an IRS ruling to the contrary, certain U.S. corporations have apparently interpreted section 28(a) to provide that a U.S. corporation whose principal office is in the Virgin Islands may qualify as an "inhabitant of the Virgin Islands". Under this interpretation, the U.S. corporation would avoid all taxation on income derived from or effectively connected with the United States. This would be possible because, as a Virgin Islands inhabitant, it would not be subject to U.S. tax and, under the mirror system, it would be liable for Virgin Islands tax only on income derived from or effectively connected with the Virgin Islands. Whether or not a U.S. corporation can qualify as an inhabitant of the Virgin Islands, and thereby avoid U.S. tax, is the subject of a pending revenue ruling.

A further means of tax avoidance may be available to the parent corporation of a U.S. corporation which qualifies as a V.I. inhabitant. Dividends paid by such a corporation to its parent would arguably be eligible for a 100 percent dividends-received deduction, and thus be free of U.S. tax. At the same time, the parent corporation could claim a foreign tax credit for any withholding tax paid to the Virgin Islands with respect to such dividends. This foreign tax credit could offset the parent's U.S. tax liability on income sourced in low-tax foreign countries. In such a case, the foreign tax credit would not serve its intended purpose of relieving double taxation.

Current law may not provide for a reasonable solution either to the proper treatment of U.S. corporations under section 28(a) of the Revised Organic Act or to the inequitable treatment of U.S. citizens under the V.I. mirror system. The Virgin Islands has several times expressed interest in legislation which would provide for identical treatment of U.S. and V.I. persons under the mirror system.[13]

## 2. Tax incentives for investment in the Virgin Islands

The Virgin Islands has a tax-incentive program which rebates to qualifying companies 90 percent of territorial taxes on Virgin Islands-source income. Section 934 of the *Federal* Internal Revenue Code limits such rebates of Virgin Islands taxes to those corporations 80 percent of whose gross income is Virgin Islands-source and 50 percent of whose income is derived from the active conduct of a trade or business in the Virgin Islands. Provisions of the *Virgin Islands* law establish other requirements which a corporation must meet in order to qualify for the tax rebates. The principal requirements are that it:

— invest at least $50,000, exclusive of inventory, in a Virgin Islands industry or business;

— agree in writing to give preference in employment and contracting to Virgin Islands residents and corporations;

— obtain approval from the Commissioner of Labor prior to hiring nonresident workers; and

— conform to ecological standards established by Federal or local law.

In addition to these specific requirements which must be met by an applicant for V.I. tax relief, the Virgin Islands consider applications in light of the following general guidelines:

— the extent to which the proposed enterprise may pollute the environment;

— the applicant's requirements for utilities, social services, and other resources;

— the applicant's capacity to employ Virgin Islands resident labor; and

— the proposed industry's compatibility with existing businesses in the Virgin Islands.

Corporations which are beneficiaries of the V.I. Industrial Development Program may receive rebates of 90 percent of corporate income taxes paid, rebates of 90 percent of customs duties, and/or 100 percent exemptions from the V.I. real property tax, gross recepts tax and/or excise tax. Any particular package of benefits is negotiated between the applicant and the V.I. Industrial Development Commission. Subsidies and exemptions are permitted for 10 years, but the beneficiary under the Industrial Development Program may be granted renewal of those benefits subject to the approval of the Governor of the Virgin Islands.

A corporation which qualifies under section 934 and the V.I. Industrial Development Program for a rebate of 90 percent of its income taxes, pays a maximum income tax rate in the Virgin Islands of 4.6 percent. If the corporation is also deemed to be a V.I. inhabitant under section 28(a) of the Revised Organic Act, then it is not subject to Federal tax. In 1977, nine U.S.-controlled corporations received the benefits of the V.I. income tax rebates and of section 28(a). The income tax subsidy granted these nine corporations amounted to $13.5 million in 1977. This figure is the total amount of

13. A 1975 resolution of the Virgin Islands legislature urged the U.S. Congress to adopt legislation to "eliminat[e] the so called 'mirror system' of taxation in all instances in which said system results in any United States citizen resident in the Virgin Islands or any Virgin Islands corporation being denied any deduction, credit, election or exemption under the Internal Revenue Code of 1954, as amended, by reason of the fact that the Virgin Islands is a separate taxing jurisdiction from the United States."

Federal taxes foregone as a result of section 28(a),[14] but only a small part of the Virgin Islands taxes foregone as a result of the V.I. tax-incentive legislation. The full amount of V.I. taxes foregone includes the tax relief provided to approximately 57 V.I. corporations, in addition to the nine U.S.-controlled corporations.[15] It also includes the customs tax rebates and exemptions from V.I. property tax, gross receipts tax, and excise tax. Data are not available to estimate the total amount of taxes foregone by the Virgin Islands.

In 1977, the income tax foregone per employee of the nine U.S.-controlled corporations varied between $59,000 for one company and zero in the case of two companies with net losses. The $59,000 figure is five times larger than the average compensation paid to employees of these companies. The average income tax forgiveness per employee was $4,300, or 36 percent of the average compensation of these employees.[16]

### 3. "Covering over" of Federal and territorial taxes

The Revised Organic Act in section 28(a) provides that:

> "the proceeds of the United States income tax on the inhabitants of the Virgin Islands ... shall be covered into the treasury of the Virgin Islands, ... provided that ... such persons shall satisfy their income tax obligations under applicable taxing statutes of the United States by paying their tax on income derived from all sources both within and outside the Virgin Islands into the treasury of the Virgin Islands."

Since U.S. government employees stationed in the Virgin Islands are considered to be "inhabitants of the Virgin Islands", the Internal Revenue Service pays over to the Virgin Islands treasury U.S. income taxes imposed upon the compensation of U.S. government employees for services performed in the Virgin Islands. The Internal Revenue Service has interpreted section 28(a) also to authorize the covering over of U.S. income taxes withheld on wage income of individuals who were residents of the United States for part of the tax year, but residents of the Virgin Islands as of the last day of the tax year. This latter source of Federal income taxes covered over has amounted to approximately $1 million annually in recent years.

## B. Guam

### 1. Basic tax system

The 1950 Organic Act of Guam provides, in language identical to that with respect to the Virgin Islands in the Naval Appropriations Act, that "The income tax laws in force in the United States of America and those which may hereafter be enacted shall be held to be likewise in force in Guam". From 1950 to 1972, the Guam territorial income tax was administered according to a mirror system similar to that currently applied in the Virgin Islands. Because of the inequities which resulted under the Guamanian mirror system from taxing U.S. citizens not resident in Guam as nonresident aliens, Guam supported the enactment in 1972 of section 935 of the Internal Revenue Code.

*(a) Taxation of individuals*

Section 935 simplifies the application of the Guamanian mirror system to individuals. Under this section, a U.S. or Guam citizen is required to file only one tax return — with Guam if he is resident there on the last day of the year, with the United States if he is resident in one of the fifty States or the District of Columbia on the last day of the year. Section 935 also provides that for purposes of the Guamanian individual income tax, income from U.S. sources shall be treated as domestic source income; for purposes of the Federal individual income tax, income from Guamanian sources shall be treated as domestic source. Section 935 allows full credit for taxes paid to or withheld by both jurisdictions without regard to the foreign tax credit limitation. Income taxes withheld by one jurisdiction (e.g., the United States) can be claimed as a credit in the jurisdiction where the individual files his return (e.g., Guam) just as if the taxes had been withheld by the jurisdiction of residence (in this example, Guam).

While P.L. 92-606, which enacted section 935, eliminated inequities in the taxation of U.S. citizens subject to the Guamanian income tax, it gave rise to inequities in the division of revenues between the United States and Guam. Section 935 (and its companion section, 7654) apparently replaced the provisions of the Organic Act of Guam relating to the disposition of Guam taxes.[17] The Organic Act provided, in pertinent part, that "Federal income taxes derived from Guam ... shall be covered into the treasury of Guam." The legislative history of section 935 suggests that Congress intended to preserve Guam's exclusive right to tax full-year residents of Guam and citizens of Guam not resident in the United States. Accordingly, Congress provided in section 935 that such persons were "relieved of liability" for the United States income tax. However, the provisions of the 1972 law did not make Federal tax withholding obligations consistent with the liability rules set down in section 935, nor (as an

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14. In the absence of special Federal provisions, a U.S. corporation deriving income from a territory would have a tax liability to the Federal government as well as to the territorial government equal to 46 percent of its taxable income, less tax credits. To avoid double taxation, the Federal government would ordinarily grant a dollar-for-dollar foreign tax credit for taxes paid to the territory. By relieving territorial source income from Federal taxation, the United States "preserves" the benefit of any tax relief granted by the territory. The amount of the revenue loss to the Federal treasury is the difference between the taxes which would have been paid to the United States in the absence of section 28(a) and the actual tax payment to the territory. Since the territorial income tax system "mirrors" the Federal system, this amount also represents the income tax foregone by the Virgin Islands with respect to U.S.-controlled corporations.
15. Data compiled by the Virgin Islands Commerce Department show that as of December 31, 1978, there were a total of 66 active firms holding grants of tax relief from the Virgin Islands government.
16. For a detailed discussion of the data sources used in estimating the cost of the V.I. tax-incentive program to the Federal treasury, see *The Operation and Effect of the Possessions Corporations System of Taxation, Second Annual Report*, pp. 84-99.
17. Income Tax Regulations section 301.7654-1(a).

alternative) did they provide a comprehensive mechanism for the Federal government to cover these taxes over to the Guamanian treasury. Inconsistencies exist in three areas:

— The United States withholds (and retains) tax on pension payments to retired military and civil service employees resident in Guam.

— The United States withholds (and retains) tax on compensation paid to citizens of Guam serving in the U.S. armed forces.

— The United States withholds tax on compensation paid to U.S. government employees in Guam. Currently, these withholding taxes are being covered over to Guam. In 1973, the Treasury advised the IRS that it should continue to cover over these withholding taxes as if section 30 of the Organic Act had not been fully superseded.

These three issues have been of concern to both the Treasury and the Administration. The fiscal plight of Guam is increasingly serious and Guam needs to know the amount of Federal tax dollars on which it is entitled to rely. The Treasury Department indicated to the government of Guam that, if necessary, it would be prepared to seek statutory clarification.

*(b) Taxation of corporations*

Like the Virgin Islands, Guam taxes U.S. corporations as foreign corporations. Similarly, corporations chartered in Guam are considered to be foreign corporations for purposes of U.S. Federal taxation. However, P.L. 92-606 made an exception to this foreign treatment for purposes of the 30 percent withholding tax on interest, dividends, and other fixed or periodical payments. Under the new Code section 881(b), Guamanian corporations are not subject to the withholding tax on U.S.-source interest, dividends, etc. Under the "mirror image" of this provision, U.S. corporations are not subject to the withholding tax on Guam-source interest, dividends, etc.

## 2. Tax incentives for investment in Guam

Section 936 of the Internal Revenue Code allows a U.S. corporation, 80 percent of whose income is derived from a possession[18] and 50 percent of whose gross income is effectively connected with a trade or business in a possession, to claim a special credit equal to the Federal tax attributable to income from the trade or business and to "qualified possession source investment income". "Qualified possession source investment income" is derived from the reinvestment of income from a trade or business whithin the same territory. The effect of section 936 is to relieve a qualifying U.S. corporation from any Federal tax on income from a possessions trade or business or from qualified investments within the possession in which the trade or business is conducted.[19] Other income (e.g., income earned from a trade of business outside the territory) is subject to the regular Federal income tax.

Dividends paid to a U.S. corporation by a company whose Guam trade or business qualifies it for a section 936 credit must be included in the gross income of the U.S. shareholder. However, such dividends qualify for a 100 (or 85) percent dividends-received deduction, which reduces gross income otherwise subject to Federal tax. Since the dividends-received deduction eliminates most or all of the Federal tax on repatriated earnings, no foreign tax credit is allowed for withholding taxes[20] or income taxes imposed by the territory on the qualified earnings. *The effect of all these provisions taken together is that the only tax imposed on the trade or business income or the qualified possession-source investment income is that imposed by the territory.*

Under Guamanian law, corporations organized in Guam or the United States may qualify for rebates of 75 percent of Guam income taxes. In order to qualify for the rebates, a corporation must meet minimum investment and certain other requirements, such as increasing employment, replacing imports, or creating needed facilities. The rebate is allowed for up to 10 years, but may be renewed.

Section 936 is not a key factor in Guam's industrial development, since few of the tax-exempt companies in Guam are U.S. corporations. In 1977, only four corporations in Guam and American Samoa combined received section 936 benefits, resulting in a total tax saving (Federal tax foregone) of $1.1 million.

## 3. Newly enacted tax exemption measures

In 1977, the Guam legislature enacted a law (P.L. 14-32) which provides for rebates of 75 percent of Guamanian tax on foreign earned income of U.S. citizens resident in Guam. Foreign earned income is defined to include earned income derived from sources outside the United States and the U.S. territories. Since, under section 935 of the Federal Internal Revenue Code, residents of Guam are free of Federal income tax liability, the effect of this provision is to reduce the effective tax rate on foreign earned income of Guam residents to 25 percent of the rate otherwise applicable to U.S. citizens.

It is an unresolved issue whether Guam has the authority to rebate Guam taxes on foreign earned income. It is clear, however, that this exemption is contrary to the intent of Congress when it provided, in the Organic Act of 1950, that "The income-tax laws in force in the United States of America ... shall be held to be likewise in force in Guam."

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18. The term "possession" as used in section 936 includes Guam, American Samoa, and Puerto Rico. It does not include the Virgin Islands. However, the Revised Organic Act of the Virgin Islands in section 28(a) provides to "inhabitants of the Virgin Islands" benefits similar to section 936 benefits, since "inhabitants of the Virgin Islands" are relieved of the obligation of paying Federal tax by doing so in the Virgin Islands. It is unclear whether or not the term "possession" as used in section 936 includes the Northern Mariana Islands.

19. A corporation which qualifies for the benefits of section 936 may not join in filing a consolidated Federal tax return.

20. Although this provision is presently irrelevant to Guam, it could become relevant should Guam impose a withholding tax similar to the "tollgate" tax in Puerto Rico.

4. "Covering over" of Federal and territorial income taxes

Under the method imposed by sections 935 and 7654 of the Internal Revenue Code for the coordination of the U.S. and Guam income taxes, the Federal and Guam treasuries generally keep the taxes withheld by Federal and Guam withholding agents, respectively. Individuals file returns in the jurisdiction where they are resident on the last day of the year, claim a credit for taxes within both jurisdictions, and either pay additional tax or obtain a refund from the jurisdiction where they are resident.

There are three exceptions to the principle of "letting the withholding chips fall where they may:

— Federal taxes withheld on compensation paid to members of the U.S. armed forces stationed in Guam. Under the Soldiers and Sailors Relief Act, the U.S. military generally have no tax liability to Guam. The United States covers these taxes over to Guam pursuant to Code section 7654.

— Federal taxes withheld on compensation paid to civilian employees of the Federal government working in Guam.

These individuals have a tax liability to Guam in the case that they are resident there on the last day of the tax year, but can claim a credit for taxes withheld by the United States on wages which offsets their liability to Guam. As explained above, the Treasury Department would support a statutory clarification of the legal basis for covering over these amounts.

— Federal and territorial taxes on individuals with gross income of $50,000 or more and at least $5,000 in gross income from the jurisdiction in which they are not resident on the last day of the year.

These taxes are split between the Federal and territorial treasuries in proportion to the source of the income. For example, a U.S. resident with $100,000 in gross income, $10,000 of which was derived from Guam, would file a Federal return and pay taxes to the Federal government. If the withholding and estimated taxes paid to Guam represented less than 10 percent of his total tax liability, the Federal treasury would cover over the difference to the Guam treasury; if more than 10 percent had been withheld, the excess would be covered over from the Guam treasury to the Federal treasury. The United States covers these taxes over pursuant to section 7654 of the U.S. Internal Revenue Code.

### C. Northern Mariana Islands

1. Basic tax system

The Covenant to Establish a Commonwealth of the Northern Mariana Islands, the pertinent sections of which became effective in January 1979, provides in section 601 that the U.S. income tax laws are in force in the Northern Marianas "in the same manner as those laws are in force in Guam." It also provides that references to Guam in the Federal Internal Revenue Code will be deemed to refer to the Northern Mariana Islands, as well.

Pursuant to section 602 of the Covenant, the Norther Mariana Islands have authority to rebate taxes impose on local source income. The government is prohibite from rebating taxes on income derived from source outside the Northern Mariana Islands. The Norther Marianas currently rebate 100 percent of taxes collecte under the "mirrored" Internal Revenue Code o Marianas-source income. The Northern Mariana Island instead impose a tax on gross wages and salaries and business gross revenues tax. The gross wage and salar tax is levied at progressive rates ranging from zero to si percent. The business gross revenue tax is also progressive tax, with rates from zero to four percent.[21]

2. Tax incentives for investment in the Norther Mariana Islands

It is an unresolved issue whether U.S. corporation operating in the Northern Marianas may qualify fo special tax treatment under section 936 of the Federa Internal Revenue Code.

Under Marianas law, corporations receive rebates of 10 percent of the income taxes paid under the mirro system on Marianas-source income. The only territoria tax to which such income is subject is the business gros revenue tax.

3. "Covering over" of Federal and territorial incom taxes

The Covenant of the Northern Marianas provides i section 703(b) that the Federal government will pay t the Marianas treasury all Federal income taxes derive from the Northern Mariana Islands. The specific kind of taxes covered over by the United States are the sam as those enumerated for Guam (see above).

### D. American Samoa

1. Basic tax system

Alone of the four territories, Congress granted to the legislature of American Samoa the authority to impose its own income tax. In 1963, the American Samoan legislature adopted the mirror system in the America Samoan Tax Act (Revised Code of American Samoa, Title XVIII, Ch. 18.04). This Act provides that:

> "The income tax laws in force in the United States of America and those which may hereafter be enacted ... are hereby adopted by American Samoa. They shall be deemed to impose a separate territorial income tax, payable to the Government of American Samoa."

U.S. citizens who are resident in American Samoa, unlike those resident in any other territory, are not relieved of the obligation of filing a Federal tax return

21. "Commonwealth of the Northern Mariana Islands Tax Act of 1979", First Northern Marianas Commonwealth Legislature, Second Session, 1978. Chapter 1 of this Act provides for the gross wage and salary tax and the business gross revenue tax. Chapter II provides for a rebate of 100 percent of taxes collected under the "mirrored" Internal Revenue Code on Marianas-source income.

d paying Federal taxes by doing so in American moa. Instead, U.S. citizens resident in or deriving come from American Samoa file two tax returns — ne with the Federal government and one with merican Samoa. To avoid double taxation, the United ates grants a foreign tax credit against the U.S. tax bility of U.S. citizens for taxes paid on income rived from American Samoa. This treatment puts merican Samoa on an equal footing with foreign untries. It means that U.S. citizens resident in merican Samoa, like U.S. citizens at home and in reign countries, file a Federal tax return and are bject to IRS audit. It means that nationals of merican Samoa are subject to U.S. taxation only in the se that they derive income from the 50 States.

t the present time, the legislature of American Samoa considering ways to simplify its income tax system so at it is more suited to the income levels in American amoa. The legislature has stated that it believes that

> "everyone should pay something, which, given the level for the earned income credit in the Internal Revenue Code, does not occur under the mirrored or partially mirrored U.S. American Internal Revenue Code."[22]

Tax incentives for investment in American Samoa

.S. corporations operating in American Samoa may ualify for special U.S. tax treatment under section 936 f the Federal Internal Revenue Code in the same anner as domestic corporations operating in Guam. he only tax imposed on the qualified income which ich corporations derive from Amercian Samoa is that nposed by the territory.

merican Samoan law provides that certain corporaons are exempt or partially exempt from territorial come taxes. In order to qualify, the corporation must e owned by a resident of American Samoa and employ work force at least 75 percent of which consists of amoan residents. The period of tax exemption is for up o 10 years, although it may be made to terminate arlier if the cumulative amount of income taxes orgiven equals 100 percent of the net current ivestment in American Samoa.

ection 936 and related provisions of the Federal nternal Revenue Code are not a key factor in the ndustrial development of American Samoa. In 1977, here were only four corporations receiving section 936 enefits in American Samoa and Guam combined. They ccounted for a total tax saving (Federal tax loss) of 1.1 million.

. Covering over of federal and territorial income taxes

here are no covering over procedures in place between he United States and American Samoa. This imposes a urden on individuals employed by the U.S. 'ederal government in American Samoa. The tax ability of such individuals on income derived from merican Samoa is to the territory, not to the United tates.[23] Nonetheless, pursuant to section 3401(a)(8) f the Internal Revenue Code, the United States witholds income tax on compensation paid to these Federal employees. In order to satisfy their American Samoan tax obligations, these individuals must request a refund on their Federal Income tax return of the Federal withholding taxes, and then pay the refund to American Samoa, together with interest if the Federal refund is delayed.

The Internal Revenue Service has proposed a technical amendment[24] to the Internal Revenue Code which would exempt U.S. government employees in the territories from Federal withholding taxes. It would also require the United States, on the request of a territory, to enter into an agreement to withhold *territorial* income taxes on the wages of individuals employed by the U.S. government in the territory.

## IV. EVALUATION OF CURRENT SYSTEMS OF TAXATION

The current systems of income taxation in the territories may be evaluated according to three criteria: (A) raising revenue (B) equitable treatment of territorial versus stateside residents, and (C) simplicity of interpretation, administration, and compliance.

### A. Raising revenue

Congress intended that the mirror systems provide the territories with local tax revenues for meeting a part of their government expenditures. As the territorial economics grew, it was expected that the revenues collected under the graduated income tax would grow by an even larger amount and provide a source of funds for infrastructure projects as well as government operating expenses.

In fact, Virgin Islands net income tax collections declined from 15.8 percent of gross V.I. product in 1973, to 10.2 percent in 1978 (see Tabel 3). Guamanian net income tax collections declined from 12.9 percent of gross territorial product in 1973, to 7.3 percent in 1977.[25] In dollar terms, the amount of income tax collections, net of rebates, stayed roughly constant in these two territories between 1973 and 1978. This may be compared to the U.S. Federal income tax collections, which in dollar terms increased by 70 percent between 1973 and 1978, and as a percentage of GNP rose from 10.8 percent to 11.4 percent.

Members of the Virgin Islands government have stated that the comparison of the 1973 and 1978 V.I. tax/GNP ratios is misleading because the dramatic rise in the value of oil refined by one tax-exempt company in the

22. Attachment to a letter from the Legislature of American Samoa to the White House, dated October 5, 1979.
23. As explained above, the United States grants a dollar-for-dollar offset (credit) against U.S. income taxes for taxes paid to American Samoa.
24. See *Taxation and Finance,* No. 68, April 7, 1978. The Bureau of National Affairs, Inc., Washington, D.C., pp. J-1 to J-2.
25. The V.I. and Guam gross product statistics are estimates of the Commerce Department of each of the territorial governments, which note that they require further refinement.

## TABLE 3

**Virgin Islands and Guam and the United States income tax and income tax effort, fiscal years 1973—1979**

| | *1973* | *1974* | *1975* | *1976* | *1977* | *1978* | *1979** |
|---|---|---|---|---|---|---|---|
| VIRGIN ISLANDS | | | | | | | |
| Income tax, net of rebates, in million | 53.8 | 63.3 | 62.4 | 51.2 | 58.7 | 50.9 | 56.8** |
| Net income tax as percent of gross territorial product*** | 15.8% | 16.2% | 14.2% | 10.8% | 12.0% | 10.2% | n.a. |
| GUAM | | | | | | | |
| Income tax, net of rebates, in millions of dollars | 46.2 | 50.9 | 51.2 | 39.9 | 33.2 | 45.9 | 46.1 |
| Net income tax as percent of gross territorial product*** | 12.9% | 10.8% | 11.3% | 8.0% | 7.3% | n.a. | n.a. |
| UNITED STATES | | | | | | | |
| Income tax, in millions of dollars | 139,399 | 157,572 | 163,007 | 173,012 | 212,517 | 240,940 | 273,909 |
| Income tax as percent of gross national product*** | 10.8% | 11.2% | 10.7% | 10.2% | 11.3% | 11.4% | n.a. |

Office of the Secretary of the Treasury
Office of Tax Analysis
August 28, 1979.

* Estimated.
** Amount prorated from income tax collected in FY 1979 and 3-month transitional period.
*** Computed as the amount of income tax divided by gross product for the previous calendar year.

*Source:* For the territories, income tax data for FY 1976 to FY 1979 are taken from information provided by the U.S. Government Comptrollers for the Virgin Islands and Guam. Income tax data for the earlier years are taken from the chart prepared by Richard Miller for the U.S. Department of the Interior, "Funds Available to the Virgin Islands Government by Source, FY 1970 to FY 1977;" and from **Guam Needs Assessment**, U.S. Department of the Interior, Table II-1. Statistics on the V.I. gross territorial product are taken from "Comparative Growth Statistics," estimated by Jerome McElroy. Statistics on Guam gross territorial product are taken from Russell C. Kreuger and Clara M. Okada, "**The Gross Islands Product of Guam**," Department of Commerce, Government of Guam.
For the United States, income tax data are taken from **The Budget of the U.S. Government**, FY 1980 and **Annual Report of the Secretary of the Treasury on the State of the Finances, FY 1978**. Statistics on the U.S. GNP are taken from the **Survey of Current Business**, U.S. Department of Commerce, various issues.

Virgin Islands swells the gross product estimates, while it has a much smaller effect on taxable income. The Virgin Islands government has also claimed that a major cause of the decline in income tax burdens was the *Federal* revenue acts of 1975, 1976, 1977 and 1978, which reduced individual income tax liabilities. The Virgin Islands accurately points out that the U.S. revenue acts had a greater adverse impact on V.I. tax liabilities than on U.S. tax liabilities because a larger proportion of V.I. taxpayers are in the low tax brackets, which were most affected by the revenue acts. Finally, the Virgin Islands argues that it is not fair to apply effective tax rates calculated for the United States to the Virgin Islands, because "annual increases in wages in the Virgin Islands [since 1970] have averaged about six percent per year, while the states' annual yearly increases have averaged 10 percent per year."[26]

In order to evaluate these last two arguments, the Treasury Department has made a rough estimate of the impact of inflation and tax law changes on effective tax rates in the Virgin Islands. These estimates are based on the assumption that the incomes of V.I. taxpayers rose at an average annual rate of 6 percent, compared to the average annual rate of U.S. inflation of 8 percent in this period. Since U.S. inflation is exported to the Virgin Islands, the assumption of a 6 percent average annual wage increase is tantamount to assuming that the real purchasing power of Virgin Islands taxpayers dropped in this period. Based on this assumption, the average V.I. effective tax rates over all income brackets and filing statuses[27] would be as follows:

| Year | Applicable law | Average V.I. effective tax rate on earned income |
|---|---|---|
| 1973 | 1973 | 7.2% |
| 1978 | 1973 | 8.9% |
| 1978 | 1978 | 6.6% |

The table above shows that the post-1973 tax law changes only slightly over-compensated for the effect of inflation. The average effective tax rate over all income tax brackets and filing statuses in the Virgin Islands dropped by only 8 percent between 1973 and 1978, from 7.2 percent to 6.6 percent. This is less than the 14 percent drop in individual income tax collections in this period, from $37.9 million to $32.7 million. The tax law changes thus could not be the sole or even the primary cause for the sharp decline in the ratio of tax collections to gross V.I. product after 1973.

An alternative approach to measuring the impact of Federal tax law changes on V.I. income tax burdens

26. Peter Pflaum, "Changes in Federal Tax Law Adversely Affect Islands", *Virgin Islands Daily News*, September 12, 1979.
27. The average effective rates are estimated by weighting the effective tax rate for each income level and filing status by the percentage of V.I. taxpayers subject to that rate. The income distribution and filing status data were derived from a sample of 200 individual income tax returns filed with the Virgin Islands for tax year 1977.

ould be to assume that all taxes due the Virgin Islands ere in fact collected. This would mean that income tax ollections would equal tax liabilities. Using the fective V.I. tax rates on earned income for 1973 and 978, it is possible to impute the change in taxable rned income which would have had to occur to enerate the actual change which occurred in income x collections. This calculation gives rise to an timated drop in taxable income of 5.7 percent for the eriod 1973 to 1978, from $526 million to $495 illion.

| ear | Individual income tax collections | Average V.I. Effective tax rate on earned income | Amount of imputed personal income |
|---|---|---|---|
| 73 | $37.9 M | 7.2% | $526 M |
| 78 | $32.7 M | 6.6% | $495 M |

his imputed decline in personal income is at variance ith most of the growth indicators for the Virgin lands for this period. For example, it is estimated that urist expenditures in the Virgin Islands rose by 60 ercent between 1973 and 1978. The same period saw a rowth of 4 percent in the employed labor force.[28]

ı summary, the decline of V.I. income tax collections s a percentage of gross product must be attributed rimarily to factors other than changes in the Internal evenue Code. Evidence suggests that the principal ictors are (1) deficiencies in tax administration, (2) ısufficient incentives to local tax efforts, and (3) the erritorial tax-incentive programs.[29] These problems are iscussed below with reference to both the Virgin lands and Guam.

. Deficiencies in tax administration

he 1978 report of the Federal Comptroller for the irgin Islands find that the V.I. administration is lax in s tax enforcement and collection activity.[30] According ɔ a 1977 report prepared by IRS personnel at the equest of the Virgin Islands government,

"The present Tax Division salary scale is unrealistic considering salaries paid for competitive positions in other agencies."

"... since the proposed tax deficiencies for Fiscal Year 1977 amounted to an average of $705,000 per agent, it is apparent that the Virgin Islands Government could increase its revenues substantially by increasing the Revenue Agent staff and by increasing the agents' salary to attract and retain the best qualified personnel."[31]

he recently released GAO report on Guam tax dministration finds that Guam lacks procedures to lentify individuals and firms which have not filed ıcome tax returns or to cross-check information eported on income tax returns with information on ithholding statements. The GAO report also notes that nremitted withholding taxes totaled $3.5 million as of 978, and that Guam has no adequate procedures to nsure the timely collection of these or other delinquent axes. Another problem noted is that the Guam tax dministration has never used the courts to assist in the ollection of taxes due.

2. Insufficient incentives to local tax effort

In the 1970's, Federal aid has filled an ever larger gap between stagnant territorial tax revenues and the growing expenditures of the territorial governments. In addition to the regular channels of Federal aid, the Virgin Islands and Guam have received ad hoc appropriations for capital improvement and other projects and for "tax loss reimbursement." The territories' lack of full autonomy over their income tax helped them convince Congress and the Administration that they should be reimbursed for the reduction in the tax revenues resulting from their "mirroring" of changes in the Federal tax law. Their efforts produced the following results:[32]

| | Appropriations for tax loss reimbursement | |
|---|---|---|
| | Virgin Islands | Guam |
| Tax Reduction Act of 1975 | $ 8,500,000 | $15,000,000 |
| Tax Reform Act of 1976 | $14,000,000 | |
| Tax Reduction and Simplification Act of 1977 | $ 1,938,013 | $ 3,215,399 |
| Revenue Act of 1978 | Presidential veto of H.R. 13719, which would have authorized reimbursement for tax losses incurred in CY 1978 through 1982. | |

The appropriations for tax loss reimbursement to the Virgin Islands and Guam represented additional Federal aid. The Federal tax changes did not cause a reduction in the well-being of the territories, but only a transfer of funds from the treasuries of the territories to the taxpayers of the territories. If the Virgin Islands and Guam did not want to cut their tax then, they could have increased their own non-income based taxes. As of 1976, in the case of the Virgin Islands, and 1977, in the case of Guam, these territories also could have imposed a 10 percent income tax surcharge. By providing tax loss reimbursements, the Federal government was simply

28. V.I. Commerce Department.

29. A fourth factor applicable to the Virgin Islands is the decision in the *Vito* case (cited on page 15 above) that V.I.-source interest, dividends, and other passive investment income paid to U.S. persons were not subject to the 30 percent V.I. withholding tax. This decision deprived the Virgin Islands of a source of revenues it had first tapped in 1974. It therefore is not a factor which can help to account for the drop in V.I. tax effort between 1973 and 1978.

30. "Financial Condition of the Government of the Virgin Islands of the United States", U.S. Government Comptroller for the Virgin Islands, June 1978, Report No. 541-77-00, p. 10.

31. Report by the Internal Audit Division, IRS, for Fiscal Year 1977, pp. 35 and 43.

32. American Samoa was not authorized to receive reimbursement for tax losses incurred as a result of the 1975 and 1976 Federal tax changes because Congress believed that the continuing authorization to support the American Samoan government was sufficient to compensate for the reduction in territorial income tax liabilities. Congress did authorize American Samoa to receive reimbursement for the reduction in tax liabilities resulting from the Tax Reduction and Simplification Act of 1977, but American Samoa has to date not requested an appropriation.

making an additional general appropriation to these territories, while allowing territorial taxpayers to enjoy a tax reduction.

### 3. Territorial tax-incentive programs[33]

Between fiscal years 1973 and 1977, the Virgin Islands rebated $118 million in corporation income taxes to tax-exempt firms. This compares to net corporation income taxes collected in the same period of $87 million. Thus, tax rebates deprived the Virgin Islands government of 57 percent of the $205 million in total corporation income taxes collected in this five-year period.

In Guam, total income taxes and gross receipts taxes rebated in the period FY 1976 to FY 1980 are estimated to be $19.7 million.[34] This represents 10 percent of the total of the gross corporate income taxes plus gross receipts taxes collected in this five-year period.

## B. Equitable treatment of territorial versus stateside residents

Despite the fact that Federal statutes provide that "the income tax laws in force in the United States of America are likewise in force" in the Virgin Islands, Guam and the Northern Mariana Islands, U.S. residents who derive income from the Virgin Islands and U.S. citizens resident in Guam or the Northern Mariana Islands are not, in general, subject to income tax burdens comparable to those of other U.S. citizens. As explained above, U.S. residents are treated for purposes of V.I. income taxation as nonresident aliens. This makes them eligible for fewer deductions and, with respect to "not effectively connected" income, subject to possibly higher tax rates than they would be if they were V.I. residents.

In contrast, the tax systems of Guam and the Northern Mariana Islands extend more favorable tax treatment to territorial residents than is available under Federal law to other U.S. citizens. Residents of Guam may benefit from the rebate of 75 percent of their income taxes attributable to foreign earned income. Residents of the Northern Mariana Islands benefit from the rebate of 100 percent of their taxes on Marianas-source income. This forgiveness of territorial income taxes is made effective by section 935 of the Internal Revenue Code, as applied by the United States. This section provides that residents of Guam and the Northern Mariana Islands are not liable for Federal income taxes.

## C. Simplicity

In principle, basing the territorial income tax systems on the U.S. Internal Revenue Code should have minimized the problems of tax interpretation, administration, and compliance in the territories. Under the mirror systems, U.S. tax forms, instructions, and other Internal Revenue Service publications do double duty, as do training programs for revenue personnel. Because Federal court rulings are accepted as precedents in the territories, the territorial governments are spared the problems of adjudicating tax cases through their own court system.

In fact, however, the interpretation of the mirror systems raises complex questions, many of which have been answered in different ways by the courts and the Internal Revenue Service, or have yet to be answered at all. The *Vitco* case, cited [on page 15] above, is the most recent example of a shifting understanding of the Virgin Islands mirror system. This case involved the question whether the U.S. income tax regulation which exempts V.I. inhabitants from U.S. withholding taxes should be "mirrored" into the Virgin Islands tax law. The Internal Revenue Service and the V.I. tax administration took the position that V.I. tax law mirrors only the Internal Revenue Code and the regulations which derive from it, and that since the regulation in question[35] does not derive from the Internal Revenue Code, it should not be mirrored into V.I. law. The Third Circuit Court of Appeals rejected this argument. It held that the V.I. mirror system imposes a tax obligation to the Virgin Islands equivalent to what the United States would collect on the same income. This decision is certain to increase tax litigation. It raises many new questions and is at odds with the interpretation of the mirror system held in earlier court decisions.

While the Virgin Islands mirror system is more complicated than that of the other territories, issues of coordination of the Federal tax system with that of Guam and the Northern Mariana Islands also raise difficult questions of interpretation. In Guam, one of the more complex issues is the proper treatment of Federal withholding taxes on the pensions of retired Federal military and civil service employees resident in Guam (see [pp. 22-23] above). With respect to the Northern Mariana Islands, the most recent issue to come before the Treasury Department is whether the reference to "possessions" in section 936 of the Internal Revenue Code includes the Northern Mariana Islands. The law provides no clear guidance on this issue.

In addition to the complex interpretative questions raised by the territorial tax systems, these systems also create severe problems of administration. The Internal Revenue Code is exceedingly complex and the territorial tax administrations do not have the resources to enforce the Code effectively. They also have difficulty keeping abreast of changes in the Federal internal revenue laws. The V.I. tax administration was unaware until 1979 of a provision of the Tax Reform Act of 1976 alleviating a prior "inequity" in the mirror system.[36]

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33. Data on total income tax subsidies paid by American Samoa and the Northern Mariana Islands are not available.
34. Data on rebates of income taxes alone are not available.
35. U.S. Income Tax Regulations section 1.1441-4(d). This section conforms the Internal Revenue Code (as applied by the United States) to the Revised Organic Act of the Virgin Islands, section 28(a).
36. Internal Revenue Code section 6013(g) allows a married couple, one of whom is a nonresident alien, to elect to file a joint return. Under the mirror system, this provision would seem to allow a couple, one of whom was resident in the Virgin Islands, the other in the United States, to satisfy its U.S. tax liability by filing a joint return and paying taxes in the Virgin Islands.

With regard to enforcement, a difficulty of the mirror system is that they are easily abused by persons wishing to avoid and evade Federal taxes. Under the mirror systems, a resident of the Virgin Islands, Guam, or the Northern Mariana Islands is relieved of the obligation to report his income or pay tax to the United States. The IRS is not well positioned to prevent the evasion of U.S. taxes by individuals with dubious claims to residence in a territory.

Under the territorial tax rebate programs, U.S. corporations have an incentive to shift profits to the territories. Particularly in the Virgin Islands, the IRS encounters numerous and difficult transfer-pricing problems with respect to transactions between U.S. corporations and their affiliates. U.S. parents commonly lease plant and equipment to their territorial affiliates, which may have the effect of artificially inflating the income subject to a territorial tax rebate.

A further aspect of the complexity of the mirror systems is that they are difficult for taxpayers to comply with. In general, U.S. corporations operating in the territories have not been made aware that they are subject to territorial taxation under the rules applicable to foreign corporations. A sample of U.S. corporate tax returns filed with the Virgin Islands showed that they are typically filing Form 1120 as V.I. domestic corporations, rather than Form 1120F as foreign corporations. Several of the V.I. corporate returns sampled were duplicates of the corporations' U.S. income tax returns, except that a zero was indicated in the space for V.I. tax liability. These corporations apparently took the position that they owed no taxes to the Virgin Islands, perhaps on the theory that as "residents" of the United States, they satisfied their Virgin Islands tax liability by filing a return and paying taxes in the United States — as if Code section 935 applied to corporations in the Virgin Islands. In tax systems which depend as much on voluntary compliance as do the Federal and the territorial income tax systems, these discrepancies between principle and practice should be of concern.

# Virgin Islands: Residency

*The following United States Revenue Ruling (80-40) describes the case in which a United States corporation is treated as a resident of the Virgin Islands for the application of United States and Virgin Islands income tax law. However this corporation is treated as a domestic United States corporation for purposes of the dividend received deduction.*

## ISSUES

1. Is a United States corporation that has its principal office in the Virgin Islands and qualifies for certain Virgin Islands tax incentives treated as a Virgin Islands inhabitant so that it satisfies its United States income tax obligation by paying tax on its income from all sources to the Virgin Islands?

2. Is such a United States corporation a "domestic corporation" for purposes of the dividends received deduction of section 243 of the Internal Revenue Code?

## FACTS

*P*, a corporation organized in state *X*, is engaged in manufacturing in state *X*. In order to take advantage of certain income tax incentives offered by the Virgin Islands, *P* organized *S* to carry out part of *P*'s manufacturing operations in the Virgin Islands. *S* is incorporated in state *Y*.

*S* conducts all of its manufacturing operations in the Virgin Islands and derives 80 percent or more of each taxable year's gross income from Virgin Islands sources, and 50 percent or more of each taxable year's gross income from the active conduct of its business in the Virgin Islands. *S* maintains its principal office in the Virgin Islands. Management and control of *S* is in the Virgin Islands and all policy is made there. Board of directors and shareholders' meetings are held in the Virgin Islands, and all officers and some directors of *S* are Virgin Islands residents. *S*'s corporate receipts are received in the Virgin Islands and deposited in Virgin Islands bank accounts. All disbursements are made from the Virgin Islands and the corporate books and records are maintained and audited there.

## LAW AND ANALYSIS – ISSUE (1)

Section 934(a) of the Code prevents the Virgin Islands from reducing by subsidy its income tax on United States source income of a United States corporation. However, section 934(b) provides that in the case of a domestic corporation, subsection (a) shall not apply to the extent such corporation derived its income from sources without the United States: (1) if 80 percent or more of the gross income of such corporation for the 3-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within the

Virgin Islands; and (2) if 50 percent or more of the gross income of such corporation for such period or such part thereof was derived from the active conduct of a trade or business within the Virgin Islands.

Section 1.934(b)(3) of the Income Tax Regulations explains how to compute income tax liability incurred to the Virgin Islands and attributable to income derived from sources without the United States by a United States corporate inhabitant of the Virgin Islands. Section 1.934-1(b)(5) explains how to make a similar computation for a United States corporation which is not an inhabitant of the Virgin Islands. Section 934(d) of the Code provides that section 934(b) will only apply to corporations who supply the information required by section 1.934-1(d) and (e) of the regulations.

Section 1.901-1(g)(5) of the regulations states that a United States foreign tax credit is not allowable to persons who are inhabitants of the Virgin Islands.

Authority for income taxation in the Virgin Islands is derived from the Naval Appropriations Act, approved July 12, 1921 (U.S.C. 1937). This Act mirrors the income tax laws of the United States into the Virgin Islands as if the Virgin Islands legislature had adopted the Internal Revenue Code and applied it to United States persons in the same way the United States applies the Code to foreigners.

Under the mirror system the United States and the Virgin Islands are separate and distinct taxing jurisdictions even though their income tax laws arise from an identical statute applicable to each (the Code). *See* Rev. Rul. 73-315, 1973-2 C.B. 225. Thus, the effect of this mirror system of taxation is to require all persons including United States corporations incurring income tax obligations to both the United States and the Virgin Islands under Chapter 1 of the Code (as applicable in each jurisdiction) to file tax returns and pay income tax to both jurisdictions.

Section 28(a) of the Revised Organic Act of the Virgin Islands (R.O.A.), 48 U.S.C. section 1642 (Supp. 1979), makes substantial changes in this system as it affects "inhabitants of the Virgin Islands." Section 28(a) requires inhabitants to satisfy their United States and Virgin Islands income tax obligations arising under Chapter 1 of the Code (as applicable in each jurisdiction) by filing a single return with, and paying to, the Virgin Islands the Virgin Islands territorial income tax (the Code as mirrored into the Virgin Islands) on their income from all sources. *See* Rev. Rul. 60-291, 1960-2 C.B. 407.

Section 28(a) of the R.O.A. defines "inhabitants of the Virgin Islands" as all persons whose permanent residence is the Virgin Islands."

A United States corporation can qualify as an inhabitant of the Virgin Islands because (1) under section 7701(a)(1) of the Code, the term "person" includes a corporation, and (2) in adopting section 28(a), Congress rejected an attempt to limit the definition of "inhabitants of the Virgin Islands" to — "U.S. citizens" instead of "all persons". *See* Conf. Rept. No. 2105, 83rd Cong., 2d Sess. 22 (1954). Also, section 934 of the Code and section 1.934-1(b)(3) of the regulations operate on the assumption that a United States corporation can qualify as an inhabitant of the Virgin Islands. *See* S. Rept. No. 1767, 86th Cong., 2d Sess. 3 (1960).

In the present situation, all of the officers and some directors of *S* are Virgin Islands residents. All significant business operations, shareholder meetings, and Board of Directors meetings are conducted in the Virgin Islands, and *S* meets the percentage tests of section 934(b) of the Code. In addition, *S* is carrying on a trade or business in the Virgin Islands within the meaning of section 864(a). This is sufficient to constitute *S* a permanent resident, and therefore an inhabitant, of the Virgin Islands for purposes of section 28(a) of the R.O.A.

The United States does not tax a foreign corporation on its non-United States source income that is not effectively connected with the corporation's conduct of a trade or business within the United States. See sections 881(a) and 882. Therefore, under an exact mirror system, non-Virgin Islands source income that is not effectively connected with a United States corporate inhabitant's conduct of a Virgin Islands trade or business would escape territorial income tax since the inhabitant is considered a foreign corporation by the Virgin Islands. However, Congress, in section 28(a) of the R.O.A., made it clear that such income of inhabitants of the Virgin Islands would not escape taxation by using the words "paying their tax on *income derived from all sources both within and outside the Virgin Islands* into the Treasury of the Virgin Islands" (emphasis added). Thus, in effect, *S* is taxed as if it were a Virgin Islands corporation and satisfies both its United States and Virgin Islands income tax obligations by paying the Virgin Islands territorial income tax on its income from all sources. If *S* fails to file a return or pay tax on its income from all sources to the Virgin Islands, then *S* does not satisfy its U.S. tax obligations.

## LAW AND ANALYSIS – ISSUE (2)

Under section 243 of the Code, a deduction is allowed for dividends received from a domestic corporation that is subject to taxation under Chapter 1 of the Code.

As a domestic corporation, *S* is still subject to taxation under Chapter 1 of the Code as applicable in the United States. Section 28(a) of the R.O.A. merely requires *S* to satisfy this obligation by paying income tax to the Virgin Islands on *S*'s income from all sources. Thus dividends paid by *S* are not excluded from qualifying for treatment under section 243 when received by *P*.

## HOLDINGS

1. *S* is treated as an inhabitant of the Virgin Islands and must satisfy its United States and Virgin Islands income tax obligations by paying tax on its income from all sources to the Virgin Islands.

2. *S* is a domestic corporation for purposes of the dividends received deduction of section 243 of the Code.

# TAX GLOSSARY

*by H.W.T. PEPPER* *

ADVANCE CORPORATION TAX (q.v.) is payable, and the rate at which tax is deducted at source from dividends, interest, royalties and other sources liable to withholding.

**SPORTING TAXES** — In the U.S.A. an 11 percent Federal Excise tax is imposed on bows and arrows and associated equipment — in essence, a tax on hunters and sportsmen to help finance wild life preserves. Bows and arrows are increasingly used to hunt game, as being more "sporting", and less likely than firearms to eliminate the game altogether. In the U.K. there was at one time an exemption of participation sports, such as cricket or football, from entertainment tax on admission money, which the tax was, however, levied on other types of entertainment.

**SPOUSE ALLOWANCE** — In personal income tax systems it is customary to grant larger RELIEFS (q.v.) to married couples than to a single person. Whether a man supports a wife, or the wife is the breadwinner, the higher relief would apply to the joint income. See also INCOME-SPLITTING, RELIEFS.

**SPREADING** — A number of countries permit the spreading over a limited period of years of exceptional income earned within a short time, e.g. by writers, international sports stars, etc., who may earn high incomes only for a small part of their careers. Canada allows farmers (including racehorse owners and fishermen) to average their incomes over a five-year period, authors who have spent over 12 months on a manuscript may spread income over two or three years, and there are somewhat similar provisions in the U.S.A. and in the U.K.

**SPRINKLER TRUST** — The term used in the U.S.A. for a discretionary trust, i.e. a trust in which the trustees have absolute discretion to distribute the trust income in any proportions among the beneficiaries. As the beneficiary has no specified income or interest in the trust's assets, special legislation is usually necessary to counter the tax avoidance element in the arrangement.

**STAGGERING OF TAX PERIOD** — See PAYMENTS, SPREADING OF; SPREADING.

**STAMP DUTIES** — Duties, formerly — and in some cases still — paid by pre-purchase of Government stamps which are fastened by adhesion to the documents representing the dutiable transaction. Traditionally, stamp duties were charged upon legal documents such as contracts, deeds, receipts, cheques, and the conveyance, or transfer of ownership of property. Many countries have now abolished (a) minor levies on transactions and/or (b) the use of stamps in taxing those transactions which yield worthwhile revenue, although still collecting the duty by more modern methods.
In Italy, which retains many stamp taxes, deeds must be drawn up on specially stamped paper (carta bollata) obtainable from specially licensed shops. (See also FORMS, TAX, and TELEVISION LICENCE FEES.)

**STAMP TAXES** — See STAMP DUTIES.

**STANDARD DEDUCTION** — A device in the U.S.A. tax code (and previously used in Canada) whereby a taxpayer instead of detailing various minor deductions could opt instead for a "standard" deduction of 15 percent of gross income, up to a maximum deduction of $10,000, a useful administrative short-cut. The system has now been superseded by the ZERO BRACKET AMOUNT (q.v.). (See also OPTIONAL TAX.)

**STANDARD INDUSTRIAL TRADE CLASSIFICATION (S.I.T.C.)** — The classification of goods adopted by the United Nations for the compiling of statistics on international trade.

**STANDARD RATE** — In the U.K. income tax system a "standard rate" of 30 percent is currently (1979/80) applied to a broad band of taxable income in the graduated rate scale of personal income tax, and is also the rate at which ADVANCE CORPORATION TAX (q.v.) is payable, and the rate at which tax is deducted at source from dividends, interest, royalties and other sources liable to withholding.

**STATE TAXES** — See LOCAL RATES; TAXES.

**STATUTE OF LIMITATIONS** — In some countries, a general statute of limitations may apply for various purposes in connection with the administration of taxes. In Japan there is a three-year time limit on the tax authorities to determine or make corrections in a company's or an individual's tax liability. In case of fraud the limit is extended by a further two years, and taxpayers have a five-year period in which to claim adjustments. In the U.K. there is a six-year time limit for the Revenue to make additional assessments and for the taxpayer to claim refunds, but the six-year limit does not apply for additional assessments in cases of tax fraud. The position varies from country to country as to the actual time limits for Revenue and taxpayer claims.

**STATUTORY BOOKS AND FORMS** — For the purpose of administering various types of tax, the tax law may require a taxpayer's books to be kept in a certain prescribed form (in some cases the books have to be purchased from government publishers or produced by private publishers to government specifications) in order to facilitate official checking of the taxpayer's records. The forms on which income, capital, sales, etc., must be declared for tax purposes are almost invariably printed by the relevant tax department for completion by the taxpayer. The exception, since the development of data processing, is that where a business uses some form of such processing it may be permitted to render some of the information required for tax purposes in the form of the output of its mechanical or electronic equipment, which may incidentally, in some instances, be compatible with the input requirements of the tax department's own equipment.

**STEUERBELASTUNG** — (Germany) Tax burden.

**STEUERFLUCHT** — (Germany) Tax exile, i.e. removal to another country (e.g., a TAX HAVEN, q.v.) to escape or reduce tax liability in the former country.

* With the assistance of the staff of the International Bureau of Fiscal Documentation.

**STEUERGUTSCHRIFT** — (Germany) See AVOIR FISCAL.

**STEUEROASENLÄNDER** — (Germany) Tax havens (tax oases).

**STEUERPFLICHT** — (Germany) Tax liability.

**STEUERPFLICHT, BESCHRÄNKTE** — (Germany) Limited tax liability, e.g. for non-residents.

**STEUERPFLICHT, UNBESCHRÄNKTE** — (Germany) Unlimited tax liability.

**STOCK DIVIDENDS** — See BONUS SHARES TAX.

**STOCK OUTIL** — (France, Belgium, Luxembourg) BASE STOCK (q.v.) valuation method.

**STOCK RELIEF** — Because of the increased cost of financing the holding of business stocks and inventories owing to the impact of monetary inflation, provision has been made, e.g. in the U.K. tax law, for "stock relief". In the U.K. the relief, broadly, consists of a deduction of the increase in stock value over the accounting period, less 15 percent (formerly 10 percent) of the income from trade in that period. Where the value of stocks *diminishes* over any subsequent accounting period there is a RECAPTURE (q.v.) or recovery of relief previously given to the extent of the fall in value, or the unrecovered past relief, whichever is less. The relief is regarded as a deferral of tax, not a permanent reduction in liability.

**STOCK VALUATION** — The stock-in-trade or inventory of a business has to be valued for tax purposes in accordance with certain rules which usually coincide with those adopted in ordinary commercial practice and in any Companies Act or Commercial Code. Briefly, the main rules are that the same basis should be adopted at the beginning and end of the accounting period, that the stock may be valued at cost or market value, whichever is the lower, and that this basis may be applied to each individual article of stock, that reserves against possible future devaluation of stock cannot ordinarily be allowed, and that the FIFO (first in first out) method of valuation should be used. Some countries allow different bases of valuation, and exceptions to the above rules, but usually only do so on the basis that whatever approved basis is adopted should be applied consistently in subsequent years. Where the value of stock is of importance for sales taxation, similar principles would apply. The quantum and value of stock may also be of significance in a transition from one type of sales tax to another, if the stock in hand has been subjected to the old tax and it is desired to allow a rebate in respect of this tax against the liability under the new tax, which may arise when the goods are sold (see also BASE STOCK, STOCK RELIEF).

**STOOL TAX** — Small, flat-rate levies on those owing allegiance to a particular chieftain (named after the ceremonial stool, or throne of the chief) to provide the necessary revenue for local administration (see also HUT TAX, GRADUATED POLL TAX).

**STRAF (FOR URIGTIG SELVANGIVELSE** — (Denmark) Penalty (for false return).

**STRAIGHT LINE DEPRECIATION** — The method of calculating depreciation for income tax purposes on qualifying assets (in contrast to the REDUCING BALANCE METHOD, q.v.) whereby the annual allowance is based on a percentage of the original cost, ignoring subsequent wear and tear of devaluation of the asset.

**STUDENT, WORKING** — See WORKING STUDENT.

**STUMPAGE** — A royalty or other charge made by the owner of standing timber, usually calculated on the volume of usable timber removed from the forest or woodlands by the timber contractor.

**SUBPART F** — A major anti-avoidance provision in the U.S.A. tax code, relating to the income of foreign corporations which are controlled by United States shareholders. Section 951 provides for the inclusion in U.S.A. tax liability of Subpart F income which includes undistributed income of foreign (controlled) corporations.

**SUBSIDY** — The term previously used to refer to a tax which produced revenue for the monarch in Britain. "Subsidy" nowadays usually refers to a government grant rather than taxation.

**SUBSTITUTE INHERITANCE TAX** —The tax charged in some countries on "legal persons" who, not being mortal, are not subject to ordinary death or inheritance taxes. The tax usually takes the form of a small annual tax on capital.

**SUBVENTION PAYMENTS** — Payments made by one company to an associated company which, because of trading losses or for other reasons, requires financial support. In British tax law such payments may now be deducted by the paying company in computing its profits and will represent income to be brought into the calculation of profits of the receiving company.

**SUCCESSIERECHT** — (Holland) Succession duty.

**SUCCESSION** — On the takeover of a business by a new proprietor, the newcomer is usually treated as commencing a new enterprise. In the case of company takeover, however, where the shares change hands but the company remains in existence, the change in ownership may in certain circumstances be disregarded in computing the tax liability of the new proprietors. The matter is of importance in that the business may have incurred losses which may be available to the new proprietors and may thus be a factor in encouraging the salvage of a declining business by new entrepreneurs.

**SUCCESSION, DROIT DE** — (Belgium, France, Luxembourg) Succession duty.

**SUCCESSION DUTIES** — Duties chargeable upon assets passing to the successors of a deceased person (see also ESTATE DUTY, LEGACY DUTY). Such duties are usually graduated by reference (a) to the degree of CONSANGUINITY (q.v.) of the heir, and (b) to the size of the inheritance.

**SUCCURSALE** — (Belgium, France, Luxembourg) Branch establishment.

**SUM-OF-THE-YEARS'-DIGITS METHOD OF COMPUTING DEPRECIATION** — This method of computing depreciation is one of the options open to taxpayers under the U.S. tax code. the SOYD method concentrates larger allowances in the early years of the working life of an asset. If the life is estimated at ten years, the digits for each of the ten years are added, i.e. 10 + 9 + 8 + 7. . . . + 1 = 55 and the allowance for the first year is 10/55, year 2 allowance is 9/55, and so on to 1/55 for the tenth year.

**SUMPTUARY TAXES** — Indirect taxation charged upon luxuries.

[to be continued]

# Bibliography

# Books

*The publications listed in this bibliography have recently been acquired by the Bureau's library which will gladly supply further information upon request (please quote the reference numbers). They should, however, be ordered through a bookseller or direct from the publisher indicated, and not through the Bureau.*

## CANADA

### INCOME TAX ACT 1979-80

Annotated. 10th Tax Reform Edition. Consolidated with amendments to December 1979 with related tax legislation and the income tax regulations. Editor-in-Chief: H. Heward Stikeman. Toronto, Richard de Boo, Ltd., 1979. 1231 pp.
Annotations to the consolidated text of the Canadian Income Tax Law and regulations. The Canada-U.S. and Canada-U.K. income tax agreements are reproduced. (B. 102.471)

### MATERIALS ON CANADIAN INCOME TAX

Fourth edition. Editors: Warren Grover and Frank Iacobucci. Toronto, Richard de Boo, Ltd., 1980. 1291 pp.
Textbook by 27 contributors explaining income tax in Canada. Resource taxation, by Peter Cumming, has been added. (B. 102.530)

### PROPERTY ASSESSMENT IN CANADA

Third edition. By Frederic H. Finnis. Toronto, Canadian Tax Foundation, 1979. 154 pp., $7.
Monograph on property tax in the Canadian tax system which ranks fourth as a source of tax revenue in the country after personal and corporation income taxes and sales taxes. (B. 102.470)

### PROVINCIAL AND MUNICIPAL FINANCES 1979

Toronto, Canadian Tax Foundation, 1979. 275 pp.
Ninth biennial publication of manual on Canadian public finance. (B. 102.478)

### PROVINCIAL RETAIL SALES TAX HANDBOOK

By Joseph R. Brown and James S. Draffin. Toronto, Richard de Boo, Ltd., 1979. 854 pp.
Summary of the sales taxes in British Columbia, Manitoba, New Brunswick, Newfoundland, Nova Scotia, Ontario, Prince Edward Island, Quebec and Saskatchewan. The sales tax statutes for each province have not been completely reproduced. (B. 102.477)

### TAXATION AND ESTATE PLANNING

By Maurice C. Cullity and Robert E. Forbes. Toronto, Richard de Boo, Ltd., 1978. 574 pp.
Textbook explaining federal and provincial succession duty, gift tax and estate planning in Canada. (B. 102.476)

## CHINA (People's Rep.)

### CHINA. A GENERAL SURVEY

Geography — history — politics — economy — culture. By Qi Wen. Beijing, Foreign Languages Press, 1979. 252 pp.
Informative book designed to provide a brief introduction to China's present situation since the founding of the People's Republic 30 years ago. A short description is given of the history and geography of the land, its political and economic situation (including fiscal revenues and expenditures) and its cultural development. (B. 51.491)

## COMMON MARKET (EEC)

### BUSINESS ENTERPRISES IN THE EEC

Formation, taxation and other useful information, in comparative format. By John C. Pollock and Anthony D. Jackson. London, The Institute of Chartered Accountants in England and Wales, 1979. 77 pp. (B. 102.485)

### INVENTAR DER STEUERN

Brussels, Commission of the European Communities, 1979. 716 pp.
Outline of taxes (in German) levied by the central and local authorities in the member states of the European Communities: Belgium, Denmark, German Federal Republic, France, Ireland, Italy, Luxembourg, the Netherlands, United Kingdom. The situation is set out as of December 31, 1978 and replaces the 1976 edition. Also available in English ("Inventory of Taxes"). (B. 102.461)

## CYPRUS

### CYPRUS TAX ADVANTAGES AND EXEMPTIONS

2nd Edition. By Chrysses Demetriades. Limassol, Cypropublico, Ltd., 1979. 33 pp.
Summary of tax incentives and business opportunities in Cyprus. Attention is paid to double taxation agreements concluded by Cyprus. (B. 102.482)

## DENMARK

### SKATTE TABELLER 1980

36. Årgang, By. V. Spang-Thomsen. Copenhagen, A/S Skattekartoteket Informationskontor, 1980. 137 pp.
Income and net wealth tax tables for 1980 with annotations. (B. 102.467)

## FRANCE

### LE DROIT DE LA CONSTRUCTION

6e Edition 1980. By Georges Liet-Veaux. Paris, Librairies Techniques; Editions Celse, 1980. 411 pp., 120 Ffr.
Sixth edition of monograph describing the French regulations on real property from both the private as well as administrative points of view. The status of building construction businesses and the levy of value added tax thereon are dealt with. (B. 102.456)

### LAMY FISCAL

Tome I: taxes sur le chiffre d'affaires; enregistrement et timbre;

fiscalité immobilière; impôts directs locaux. Tome II: impôts directs d'Etat; contrôle, contentieux, pénalités. Paris, Lamy S.A., 1980. 792 + 1022 pp.
Annual publication containing an explanation of French tax legislation. Supplements are issued regularly in order to keep the two volumes up to date. (B. 102.534)

## GERMAN FEDERAL REPUBLIC

### BETRIEBSAUFSPALTUNG IM STEUERRECHT

2. Auflage. By Helmar Fichtelmann. Cologne, Peter Deubner Verlag, 1979. 59 pp., 19.80 DM.
Second edition of a study which presents a more practical approach to the "Betriebsaufspaltung" (splitting of an enterprise into one company which possesses the fixed assets and another company which runs the current activities). It is mainly based upon the decisions of the West German Supreme Tax Court. (B. 102.520)

### BUNDESGESETZ ZUR GRUNDERWERBSTEUERBEFREIUNG

By Ernst Paul Boruttau, Otto Klein, Hans Egly and Heinrich Sigloch. Munich, Verlag C.H. Beck, 1979. 218 pp., 29.80 DM.
Book published in addition to the basic volume on real property transfer tax by the same authors, discussing the 1977 Law on Exemption from Real Property Transfer Tax in the case of acquisition of one-family and two-family dwelling houses, with references to case law and other related laws. (B. 102.518)

### DIE GmbH & CO KG IM STEUERRECHT

3. Auflage. By Helmar Fichtelmann. Cologne, Peter Deubner Verlag, 1979. 80 pp., 19.80 DM.
Third edition of a monograph on the civil law aspects and tax aspects of the GmbH & Co KG (limited partnership with a limited liability company as general partner). (B. 102.521)

### GRUNDERWERBSTEUERGESETZ

10. Auflage. By Ernst Paul Boruttau, Otto Klein, Hans Egly and Heinrich Sigloch. Munich, Verlag C.H. Beck, 1977. 2014 pp., 178 DM.
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## THE NETHERLANDS

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Januari 1980. Deventer, Kluwer, 1980. 82 pp., 14.75 Dfl.
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### FOREIGN INVESTMENTS IN THE NETHERLANDS

Revised January, 1980. The Hague, Fenedex, 1980. 37 pp. (B. 102.487)

### OMZETBELASTING

2e herziene druk. By J. Reugebrink. Deventer, Fed, 1979. Fiscale Studieserie No. 6. 360 pp., 69 Dfl.
Second revised edition of monograph on value added tax in the Netherlands comprising two parts: the first deals with the theoretical aspects of turnover tax as a consumption tax; part two deals with the problems arising in practice under the Dutch turnover tax law. (B. 102.524)

## NORWAY

### TAXES IN NORWAY

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Revised edition describing in English the taxes on income and net worth in force at the end of 1979 in Norway. (B. 102.490)

## O.E.C.D.

### THE 1978 TAX/BENEFIT POSITION OF A TYPICAL WORKER IN OECD MEMBER COUNTRIES

Paris, Organisation for Economic Co-operation and Development, 1979. 47 pp. (B. 102.474)

## SWEDEN

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Monograph explaining international arbitration under Swedish law. (B. 102.468)

### SURVEY OF ACCOUNTING PRACTICES IN LARGER SWEDISH COMPANIES 1979

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## UNITED KINGDOM

### INTRODUCTION TO REVENUE LAW

By F.R. Davies. London, Sweet & Maxwell, 1980. 341 pp., £8.50.
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### OECD ECONOMIC SURVEYS: UNITED KINGDOM

Paris, Organisation for Economic Co-operation and Development, 1980. 63 pp. (B. 102.462)

### ROWLAND'S TAX GUIDE 1979-80

Third edition. Editors: Nigel Eastaway, David Trill, London, Butterworths, 1980. ± 900 pp., £17.50.
Supplementary tax guide to Butterworth's Yellow and Orange Tax Handbooks containing actual legislation in force. This third edition states the law as of August 1, 1979. (B. 102.444)

### SIMON'S TAX CASES

Cumulative tables and index 1973-1979. London, Butterworths, 1980. 111 pp.
The cumulative table and index contains complete and systematic indices to all cases reported in the 1973 to 1979 volumes of Simon's Tax Cases. (B. 102.455)

### TAXATION INCOME TAX MANUAL

Fourteenth edition. By A.L. Chapman. London, Taxation Publishing Company, Ltd., 1979. 762 pp., £12.50.
Revised income tax manual explaining the income tax law as

amended by the Finance Acts of 1977 and 1978 and the two Finance Acts of 1979. Developments in case law and revenue practices have been incorporated. (B. 102.465)

### TOLLEY'S TAX PLANNING

Edited by A.L. Chapman. London, The Tax Lawyer Publishing Company; Tolley Publishing Co., Ltd., 1980. 644 pp., £15.
The purpose of this book is to help taxpayers, whether they be multinationals or individuals in retirement, to maximise the after tax return from their business transactions or investment. Apart from capital transfer tax, all the principal taxes are covered; even value added tax is included. (B. 102.466)

### U.K. TAX SAVINGS FOR THE HIGHER PAID (1979)

By L.R. Blackstone and D.S. Franks. London, The Economist Intelligence Unit, Ltd., 1979. 110 pp. (B. 102.493)

## U.S.A.

### AMERICAN FEDERAL TAX REPORTS

Second series. Vol. 43, table of cases to vols 41-43. Englewood Ciffs, Prentice-Hall, Inc., 1979.
This bound volume contains unabridged federal and state court decisions arising under the federal tax law (previously reported in Prentice-Hall Federal Taxes) on income tax, estate and gift tax and excise tax. (B. 102.541)

### BORDER TAX ADJUSTMENTS ON COMMODITIES AND INCOME

By M.B. Krauss and G.C. Hufbauer. Washington, Office of Tax Analysis, U.S. Treasury Department, 1976. OTA Paper No. 18, September 1976. 38 pp. (B. 102.491)

### DESTINATION PRINCIPLE BORDER TAX ADJUSTMENTS FOR THE CORPORATE INCOME AND SOCIAL SECURITY TAXES

By G.N. Carlson, G.C. Hufbauer and M.B. Krauss. Washington, Office of Tax Analysis, U.S. Treasury Department, 1976. OTA Paper No. 20, November 1976. 26 pp. (B. 102.492)

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The international aspects. Edited by Robert Feinschreiber. Greenvale, N.Y., Panel Publishers, 1979. 191 pp.
Anthology dealing with the international aspects of earnings and profits of controlled foreign corporations under U.S. tax legislation. Topics include: "Using the computer to compute earnings and profits" by J. Robert Arthur and "A new strategy for recognizing exchange gains and losses" by Jane Lillie. (B. 102.474)

### INTERNAL REVENUE CODE

Including 1979 amendments. Income, employment, estate and gift tax provisions. Chicago, Commerce Clearing House, Inc., 1980. 2325 pp., $11.
Annotated text of the Internal Revenue Code with respect to income tax and estate and gift tax provisions as amended through the end of 1979. (B. 102.545)

### REPORTS OF THE UNITED STATES TAX COURT

October 1, 1978, to March 31, 1979. Volume 71. Reporter of Decisions: Mary T. Pittman. Washington, U.S. Government Printer, 1979. 1230 pp.
Bound volume containing relevant U.S. Tax Court decisions. (B. 102.542)

### SUBPART F — FOREIGN SUBSIDIARIES AND THEIR TAX CONSEQUENCES

Edited by Robert Feinschreiber. Greenvale, N.Y., Panel Publishers, 1979. 260 pp.
Anthology containing papers dealing with the aspects of foreign subsidiaries and their tax consequences. Topics include: "The Branch Rule and the Subpart F Exclusions" by Michael D. Raskhin; "Foreign Personal Holding Company and Subpart F Status" by Philip J. Erbacher. (B. 102.472)

### TAX CREDIT CLAIMED BY HAWAII RESIDENTS 1978

Excise tax credit, renter's tax credit, child care expense tax credit, solar energy device tax credit, hot water heater insulation tax credit. Honolulu, State of Hawaii, Department of Taxation, 1180. 31 pp.
Study presenting the different tax credits for Hawaii residents based on tax returns filed in 1979 on 1978 income. (B. 102.512)

# IFA NEWS

### Meeting of the Austrian and German Branches on May 9 and 10, 1980 in Salzburg (Austria)

The Austrian and German branches of IFA organised on May 9-10, 1980 their third bilateral meeting. Papers were read by:

- Dr. Wenzel (German Federal Republic) on the practical problems resulting from the recent reform of the German VAT system especially with a view to transactions with Austria;
- Dr. Bechinie and Dr. Halpern from Austria and Dr. Willemsen from the German Federal Republic discussed the current tax situation in their countries with Dr. Bechinie paying special attention to the work of the Austrian Tax Reform Committee which completed its task a few months ago;
- Dr. Miehler and Dr. Menck from the German Federal Republic and Dr. Huber from Austria reported on the current situation with respect to the exchange of information between the tax administrations of the two countries.

More detailed information is to be found in the German language in *Internationale Wirtschaftsbriefe* of June 10, 1980 at 343.

### National meeting of the Swiss Branch on June 20, 1980 in Zurich

On June 20, 1980 the Swiss Branch of IFA will hold its 30th national meeting in Zurich. Subject of discussion will be the taxation of annual rental value of real property and incentives for the acquisition of owner-occupied dwelling houses.

# Loose-Leaf Services

**Received between April 1 and April 30, 1980**

## AUSTRALIA

AUSTRALIAN INCOME TAX — LAW AND PRACTICE:
- Bulletin
  releases 1 and 2
- Cases
  releases 1, 2, 4 and 5

Butterworths, Pty., Ltd., Chatswood.

## BELGIUM

DOORLOPENDE DOCUMENTATIE INZAKE BTW/LE DOSSIER PERMANENT DE LA TVA

release 114
Editions Service, Brussels.

GUIDE FISCAL PERMANENT

release 413
Editions Service, Brussels.

VAKCURSUSSEN

release 115
Ministry of Finance, Brussels.

## CANADA

CANADA INCOME TAX GUIDE REPORTS

release 136
CCH Canadian, Ltd., Don Mills.

CANADA TAX LETTER

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Richard de Boo, Ltd., Toronto.

CANADA TAX SERVICE — RELEASE

releases 264-272
Richard de Boo, Ltd., Toronto.

CANADIAN CURRENT TAX

releases 12-16
Butterworths, Scarborough.

CANADIAN INCOME TAX:
- Tax planning and management
  releases 35-38
- Revised
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Butterworths, Scarborough.

CANADIAN TAX REPORTS

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CCH Canadian, Ltd., Don Mills.

DOMINION TAX CASES

releases 9-12
CCH Canadian, Don Mills.

FOREIGN INVESTMENT IN CANADA

Report Bulletin
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Prentice-Hall of Canada, Scarborough.

## COMMON MARKET (EEC)

HANDBOEK VOOR DE EUROPESE GEMEENSCHAPPEN:
- Kommentaar op het EEG, Euratom en EGKS verdrag; verdragsteksten en aanverwante stukken
  release 208

Kluwer, Deventer.

## FRANCE

BULLETIN DE DOCUMENTATION PRATIQUE DES IMPOTS DIRECTS ET DES DROITS D'ENREGISTREMENT

release 7
Editions Francis Lefebvre, Levallois-Perret.

BULLETIN DE DOCUMENTATION PRATIQUE DES TAXES SUR LE CHIFFRE D'AFFAIRES ET DES CONTRIBUTIONS INDIRECTES "FISCALITE PRATIQUE"

releases 6 and 7
Editions Francis Lefebvre, Levallois-Perret.

DICTIONNAIRE PERMANENT — DROIT DES AFFAIRES

releases 51 and 52
Editions Législatives et Administratives, Paris.

DICTIONNAIRE PERMANENT — FISCAL

releases 74, 75 and 76
Editions Législatives et Administratives, Paris.

JURIS CLASSEUR — CHIFFRE D'AFFAIRES — COMMENTAIRES

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Editions Techniques, Paris.

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## GERMAN FEDERAL REPUBLIC

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- Loonbelasting 1964
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- Omzetbelasting 1968 (BTW)/1978
  release 12
- Successiewet
  release 24

Noorduijn, Arnhem.

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— Tarief voor invoerrechten
  release 255
— Algemene wetgeving
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KLUWERS SUBSIDIEBOEK
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OMZETBELASTING (BTW) IN BEROEP EN BEDRIJF
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Tome I, release 64
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Prentice-Hall, Inc., Englewood Cliffs.

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Commerce Clearing House, Inc., Chicago.

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release 3
Prentice-Hall, Inc., Englewood Cliffs.

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*Management Centre Europe:* Managing and Developing Foreign Subsidiaries Seminar (including: Tax in international operations), Brussels (Belgium), July 2-4 (English).

*Management Centre Europe:* International Tax Management Seminar (including: Anti-tax haven legislation, tax treatment on technology import and technology export, handling of disputes between tax administrations), Brussels (Belgium), July 10-11 (English).

## AUGUST 1980

*Management Centre Europe:* International Cash Management Seminar (including: International tax aspects in cash management), Brussels (Belgium), August 20-22 (English).

## SEPTEMBER 1980

*Business International Institute/Asia:* Doing business in and with Thailand (Seminar) (including taxation), Bangkok (Thailand), September 1-2 (English).

*Business International Institute/Asia:* Doing business in and with Korea (Seminar) (including taxation), Seoul (Republic of Korea), September 15-16 (English).

*IXth Luso-Hispano-Americanas Meeting of Tax Studies:* Influence of taxation on the financing of enterprises; the family unit as taxable subject, Porto (Portugal), September 28-October 3 (Portuguese, Spanish).

*34th Annual Congress of I.F.A.:* I. The dialogue between the tax administration and taxpayer up to the filing of the tax return: II. The determination of the source of income. For the seminar the subject is the flight to tax havens, their use and abuse, Paris (France), September 14-19 (English, French, German, Spanish).

## NOVEMBER 1980

*Confédération Fiscale Européenne (C.F.E.):* Second Congress of European Tax Consultants (subject: "La pratique de la Fiscalité en Europe"), Rome (Italy), November 6 and 7 (English, French, German).

*Management Centre Europe:* International Tax Management Seminar (Discussion of tax problems in today's multinational environment), Munich (German Federal Republic), November 10-11 (English).

## APRIL 1981

*Management Centre Europe:* Fourth MCE International Tax Conference. Chairman: Prof. J. van Hoorn Jr., Co-Chairman: A.G. Davies C.B.E. Main subjects: Transfer pricing; Government and business views on tax avoidance, Taxation of international leasing small meeting groups directed by members of the faculty, Munich (German Federal Republic), April 8-10 (English).

## SEPTEMBER 1981

*35th Annual Congress of I.F.A.:* I. Mutual agreement procedure and practice; II. Unilateral measures to prevent double taxation, Berlin (German Federal Republic), September 21-25 (English, French, German, Spanish).

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International Fiscal Association (I.F.A.): General Secretariat, Woudenstein, Burgemeester Oudlaan 50, P.O. Box 1738, 3000 DR Rotterdam (Netherlands).

Management Centre Europe, Avenue des Arts 4, B-1040 Brussels (Belgium).

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# SCHEDULAR AND GLOBAL SYSTEMS OF INCOME TAXATION:
# THE EQUITY DIMENSION

by Sylvain R.F. Plasschaert*

## I. INTRODUCTION: DEFINITION OF SCHEDULAR, GLOBAL AND MIXED SYSTEMS

The present paper is part of a broader enquiry into "schedular, global and mixed systems of income taxation", with particular reference to developing countries. Other policy-oriented chapters compare the schedular and global prototypes of income taxation with respect to their likely economic effects and their administrative feasibility and efficiency.

In order to render this paper self-contained, the reader is reminded of the following fundamental concepts.

In a *schedular* income tax system, each of the various *incomes*, such as salaries, dividends or business profits, that flow to a particular taxpayer, is subject to a separate tax. In other words, the schedular system of income taxation consists of a co-ordinated set of separate taxes on various types of *income*.

In a *global* income tax, all (partial) *incomes*, from whatever source derived, that accrue to the same taxpayer, are taxed jointly as a single mass of *income*.

A *mixed or composite* system consists merely of a set of schedular taxes and of a global-type tax. Thus, a mixed frame of income taxation is not original, structurally speaking. In a mixed system, a "complementary" global tax is superimposed on a schedular system.

The separate or aggregate taxation of income carries some implications for the design of the income tax. Thus, in a coherent or "rational" schedular system, in which the basic tenets that underly the schedular approach would be scrupulously adhered to, each type of income ought to be taxed, without any reference to the personal circumstances of the income-recipient. In other words, the schedular tax system essentially has an objective character. Each "schedule" carries a flat or proportional rate; capital incomes are subjected to a higher rate than incomes from labour. In "rational" global-type systems, on the contrary, such reference or personalization is quite appropriate, as are progressive rates.

In actual "empirical", or "historical", tax systems, however, there are numerous deviations from the parameters and rules, that would follow from the uncompromising application of the underlying paradigms of the respective schedular and global systems.

The present paper discusses the equity aspects of the schedular or global tax systems, but contains no analysis of the merits and drawbacks of the mixed or composite system.

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## II. IN GENERAL: PROGRESSIVE AND PROPORTIONAL FORMULAE

The equity dimension is of overriding significance for any tax system and any particular tax. Explicit or implicit equity standards determine how the tax burden is apportioned over the taxpaying subjects. The latter will only psychologically and politically accept the tax if the overwhelming majority of the citizens view the tax as equitable — unless all opposition or disagreement is forcibly suppressed.

Unfair taxes are morally repulsive. But one must admit that the concept of tax equity is elusive and value-infected and owes more to ethical considerations and political judgements than to unassailable scientific guidelines.

The burden of the income tax is distributed over the taxpaying units, through tax formulae, which are applied to the statutory taxable base. One distinguishes a regressive, proportional or progressive rate — more commonly, a series of rates — according to whether the tax liability rises more slowly, at the same pace or faster than the taxable base. In somewhat simplified form, progressive taxes take an increasing share of income as the latter rises. By definition, in a progressive rate formula and provided progressivity is maintained over the whole range of taxable income, the marginal rate (the tax rate on additional units or brackets of taxable income) exceeds the average rate of income tax. Under those circumstances, the marginal rate will rise (from zero on the first, untaxed bracket) to the top marginal rate, say 60 percent or 80 percent, which is still held applicable.

There is no need to investigate the various conceivable slopes of a set of progressive rates. Suffice it to say that in most actual tax systems, the marginal — and hence, the average — rate does not rise in a steady, but in a discrete or non-continuous fashion: the given marginal rate applies to a given segment or bracket of the income ladder — as explained, a moment ago. Besides, the combination of flat rates with an initial exemption on the first bracket of income results in the so-called Bentham progression. For example, if a 30 percent flat rate applies to taxpayers A, B and C, with an income of respectively $ 2,000, $ 10,000 and $ 30,000, and if all three taxpayers enjoy an initial exemption of $ 2,000, the average tax ratios, as a percentage of the above-mentioned income levels, will amount to respectively zero for A, 24 percent for B and 28 percent for C. This indirect form of progression is also called the "degressive" progression, as the percentage tax "saving" resulting from the initial exemption declines as income increases.[1]

Rate formulae such as progressive rate schedules or proportional rates are only technical parameters. While, conceivably, rates could be assigned at random to various types or levels of income, neither the citizens nor the legislators would accept the resulting chaotic interpersonal distribution of tax burdens. The latter must reflect well-established and widely-accepted tax equity principles which are implemented through appropriate tax formulae.

In schedular tax systems, by definition, each category of income is taxed separately and made subject to a tax rate. Historically, the schedular compartmentalization has been rationalized in the light of the "quantitative discrimination" principle, according to which each schedule should carry a flat rate: those rates, however, must be differentiated according to the nature of each of the incomes, with incomes from capital being subjected to a distinctly higher flat rate than earnings from labor inputs. Global systems, on the other hand, utilize progressive tax formulae.

A simplified outline of the diverging distributional pattern of tax burdens over the various taxpayers is shown in Figure 1. The schedular system carries a 20 percent flat rate on labour income, and a 40 percent rate on incomes from capital, whatever the level of such incomes. The global tax carries a discrete progressive formula, whereby there are five brackets. The first slice of income is exempted, or, in other words, is subjected to a zero rate. The (marginal) rate schedule on each of the following brackets of taxable income starts with 10 percent and rises by 20 percent for each of the subsequent brackets of income, to reach a final marginal rate of 70 percent. In progressive formulae the marginal rate rises faster than the average one. A dotted line shows how, in this particular case, the average rate rises over the income spectrum.

This graph is purely hypothetical and highly simplified. Two particular preoccupations should be noted. First, whether the two systems would yield the same amount of revenue would depend on the underlying distribution of incomes. We hypothesize here that such equal-revenue distribution exists; this would probably require that, as in the graph, few exemptions would be granted, not even on labor incomes. Second, in order to avoid some distortions, to be discussed in section VI, theoretically all exemptions for low-income levels in the categories of the schedular tax should be barred; however, the equity arguments in favor of a zero rate on such low-income brackets have proven quite strong in historical tax systems. Hence, the dotted line over the first stretch of the horizontal lines which depict the flat rates, respectively, on capital and labor income.

In this chapter, we first evaluate the basic rationales which have been adduced to support the above-mentioned interpersonal[2] distribution of tax burdens in the two systems.

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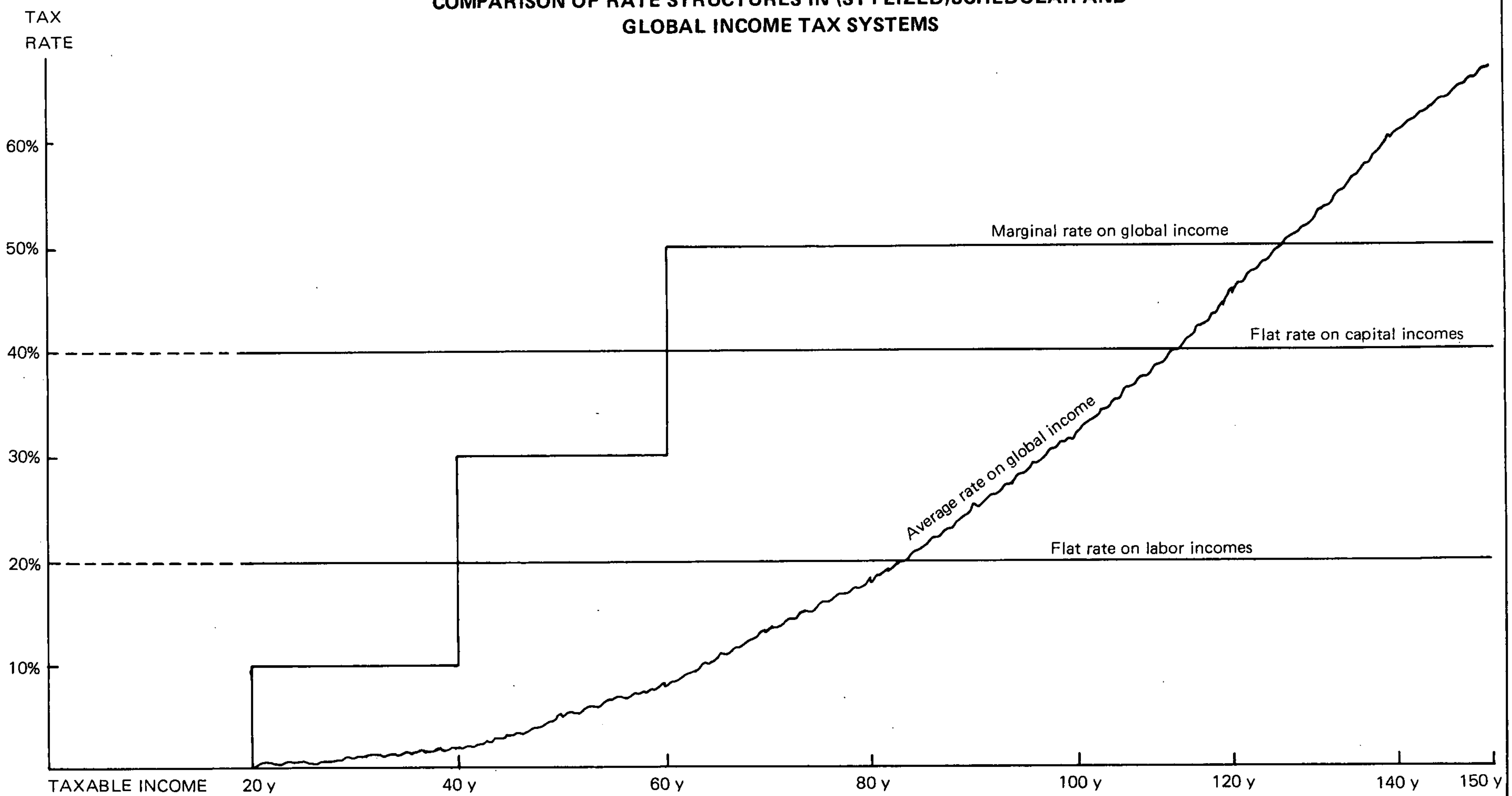
1. In this case, progressivity emerges when the resulting average tax rate is related to "taxable income gross of the allowance". It would be wrong to infer that the tax burden is thereby unjustifiably lowered. The statutory rates must apply on statutory income. Modern income taxes contain a basic allowance. Hence, the tax formula should only hit "income net of the allowance". But an unwarranted decline, in equity terms, in the effective rate, as against the nominal (30 percent) rate, would result if each of the taxpayers were to evade US$ 2,000 of statutorily taxable income.

2. We abstract, in this paper, from the rather complex problem, whether individuals or households must be viewed as proper taxable subjects, and from the impact which a separate tax on corporate net profits may have on the interpersonal distribution of income.

**FIGURE 1**

**COMPARISON OF RATE STRUCTURES IN (STYLIZED)SCHEDULAR AND GLOBAL INCOME TAX SYSTEMS**



In section VI, we revert to tax formulae and examine whether progressive rates which would reflect both the ability-to-pay principle and the socially recognized objective of some (relative) redistribution of income can be rationally built into a schedular income tax system.

In section VII, we ascertain whether, to what extent and why, numerous structural "impurities" have emerged in "historical" tax systems.

Finally, we venture some comments as to the question whether the schedular approach, based on the qualitative discrimination doctrine, which is found to be no longer appropriate for present-day developed economies, could be advocated for low-income countries.

## III. THE QUALITATIVE DISCRIMINATION THEORY

This theory, which holds that incomes from capital should be taxed at higher (proportional) rates than incomes from labor, was elaborated long ago, especially by Italian scholars of public finance.[3] Equally, Italy is probably the country where the tenets of the doctrine were fairly consistently observed until the mixed system was replaced by a global one in 1974. In principle, the flat rates which apply to the various schedules are arranged in such a way that the tax is higher as a given type of income originates more in capital assets and less in labor inputs.

A look at the Italian income tax system prevailing in the early 1960s may serve as an illustration. There were, first, two separate taxes on the return from land and buildings. The assessment was in essence based on the cadastral system; the flat rates were respectively 10 percent and 5 percent. The most important schedular tax, however, was the "imposta sui redditi di ricchezza mobile", which, in turn, was subdivided into several categories:

— category A: on incomes from financial assets, subject to a 26 percent rate, withheld at the source (dividends, however, were exempted in this category, as they were taxed as part of business profits, in category B);

— category B: on "mixed" incomes, deriving from the inputs of both capital and labor, i.e. basically on business profits. The law distinguished between joint-stock enterprises and unincorporated units. The former carried flat rates of 18 percent for the slice of taxable profits below 10 million lire, and of 24 percent above that cut-off point. Individual business-men, however, enjoyed a personal allowance of 240,000 lire; the rate was 9 percent for the income between 240,001 and 900,000 lire. Above that level, an 18 percent rate applied;

— category C1: on earnings of professionals. The first slice of 240,000 lire was exempted, the 240,001-960,000 lire bracket carried a 4 percent rate and the remainder an 8 percent rate;

— category C2: on wages and salaries. They were subject to withholding at the source at the same rates applicable to the earnings of professionals in category C1;

— income from agricultural activities, accruing to the owner of the land, were taxed, according to the cadastral system, at 10 percent. Those incomes were not entitled to personal allowances (income from tenants was subject to category B).

### Preferential treatment of labor income

A number of arguments have been advanced in support of the preferential treatment of incomes from labor over those from capital. The main argument is that labor earnings have less lasting power as, contrary to capital incomes, the flow of labor earnings may be interrupted by layoffs or by illness; even more importantly, the employment period comes to an end. In order to sustain his living during the retirement period or other periods of interrupted income flows, the worker must set aside a reserve fund out of his current income. The income stream from capital assets, on the other hand, is permanent and more regular as to its amount. In other words, nominally equal incomes from capital or labor are not equivalent in the economic sense. Equivalence can be restored, or aimed at, by way of subjecting incomes from labor to a lower (flat) rate — or, what amounts to the same, through surcharges on incomes from capital. It has also sometimes been argued that, objectively, capital embodies more "capacity-to-pay" than labor. Since, however, not objects but persons pay taxes, it appears more appropriate to use the expression "capacity-to-pay" in a more subjective setting, as discussed in the next section.

This argument can easily be faulted in terms both of principle and of present-day circumstances. Whether the stream of labor income is actually more vulnerable than capital income to interruption or termination is basically an empirical question. In *developed countries*, nowadays, almost all salaried employees and workers benefit from a comprehensive scheme of social security. The latter provides cash payments, in case of termination of labor and the payment of pensions in old age; the widow is also entitled to a pension. Medical expenses of some importance are reimbursed; unemployment payments of income compensate loss during periods of involuntary unemployment. The social security systems transcend the principle of personal insurance, whereby each person would only be entitled to benefits on the basis of and in proportion to his own contribution. As a matter of fact, the social security approach pools risks, with subsidies from the government budget frequently filling any shortfall of the contributions made by employers and employees.

It is fair to say that the present situation in developed economies with respect to the termination and inter-

3. One may mention particularly *L. Einaudi*, *Principi di Scienza della Finanza*, 4th edition (Turin, 1949) and *E. d'Albergo*, *Economia della Finanza Pubblica*, vol. I (1951). For a brief survey of the arguments involved, see *C. Brasca*, "La discriminazione fiscale a favore dei redditi di lavore", *Rivista internazionale delle scienze sociale*, July-August 1955, pp. 322-40. We do not at all imply, of course, that Italian writers have a monopoly on the subject, which has exercised the minds of many great economists, such as *J. Stuart Mill*, as early as the middle of the previous century.

ruption of labor income differs completely from that in the second half of the 19th century, when the qualitative discrimination doctrine was being formulated. The benefits, distributed nowadays through the social security system, provide a substantial cushion against the loss of income resulting from the occurrence of the abovementioned risks. Unemployment is also covered by the system. There is factual evidence that employers, in business cycle downturns, do not easily dismiss workers lest they may have difficulty in hiring them back when the economy picks up again. Besides, in several countries, lay-offs by employers involve substantial severance payments. In sum, incomes from salaried employment have become "funded" to quite an extent. Furthermore, contrary to the assumption implicit in the above main argument in favor of the discrimination principle, employee contributions are almost everywhere tax deductible. Self-employed persons, however, are clearly much less protected by the social security system; for one thing, by definition, they face the risk of periods in which they earn no income, for lack of customers: hence unemployment coverage is inconceivable for them.

It is not quite true that incomes from capital are immune against nominal or real losses. Equity investments, by their very nature, involve the risk of loss of substance; over the last inflation-ridden decade, in many countries, investments in shares appear to have been less well protected against erosion than wages, the more that the latter have widely become index-linked. The share of labor in national income has increased in most developed economies during the 1970s. The yield from fixed-rate financial instruments had trended upwards but the additional nominal yield has usually only partially compensated for the rate of inflation.

Admittedly, in *developing countries* the situation differs significantly from that in high-income countries; there also exists considerable variation amongst countries in the developing world. On the whole there is some tendency towards the extension of social security benefits to a larger number of beneficiaries. Pension benefits have been legislated for in many countries, although mostly only for public sector employees. Coverage of health hazards is rare; large segments of the population, especially in rural areas, may have almost no access to modern health services. Unemployment benefits are also non-existent and, if available at all, restricted to the private modern sector. One must also remember that in developing countries time-honored informal systems of social security exist, whereby extended families, or clans, display a significant degree of solidarity and provide needy persons, such as the elderly or unemployed, with the means to subsist. Thus, the social security system, at best, metes out modest benefits to the workers who happen to be employed in the "organized" industrial sector; a "reserve army" of un- and underemployed threatens the stability of employment in the modern sector and exerts a downward pressure on the wage level. And yet, those workers in the modern manufacturing sector often are better off, both in terms of income and of job stability, than the mass of poor peasants. In any event, the level of per capita income, the structure of employment — with most people in the agricultural sector — and the wide incidence of un- and underemployed persons would render the financing of a modern, comprehensive scheme of social security utterly untenable.

**The "lasting power" argument has only limited validity**

Is the "lasting power" argument, in favor of the doctrine of qualitative discrimination, still relevant to the developing world of our days? To the extent a general answer is warranted, considering the large divergence in actual circumstances, the case for discrimination between the two sources of income, on the basis of the above argument, is clearly a very weak one. Those who earn a comparatively high income from labor in the modern sector, such as business managers, physicians or upper-rank government officials, have sufficient means to contract insurance against the major risks and to build up a pension for their old age; salaried people in the lower-ranks can also frequently benefit from old-age pensions that are fed by their own contributions and those of their employers. But in both cases, the rationale advanced in support of the lower tax burden on labor incomes, i.e. the need to set aside reserves, which should receive preferential tax treatment, is fulfilled by way of the deductibility of the contributions of employees (and employers). Low-income recipients, such as the large numbers of self-employed peasants, artisans, and unskilled workers in urban areas without security of employment, should, by virtue of the above argument, be entitled to a lower tax burden. Yet, in the light of sound equity and administrative considerations, such low-income recipients of labor incomes remain generally outside the income-tax net in developing countries.

But, even assuming that taxable labor incomes are substantially subject to interruption and/or termination, there is a more fundamental reason why the above line of reasoning is flawed. In order to form a private retirement or unemployment fund, the wage earner must set aside a portion of his current income. Although there is still considerable disagreement among economists about the determinants of savings — which comes as no surprise, considering the variety of the motivations, and of the behavior of households — the level of the overall income of households is obviously a major, and almost certainly the main, determinant of the saving ratio.

It follows that it would hurt generally accepted norms of justice if one were to more heavily impose on an old widow who lives parsimoniously off a small securities portfolio than on the well-paid executive, by virtue of the argument that capital income requires a higher tax rate than on earnings from labor.

In essence, the lower tax urged for the "reserve fund" is predicated upon the same considerations that underly various personal allowances (such as those for dependents) which are nowadays part and parcel of the modern income tax: a portion of current income is not freely disposable but must be set aside to meet pressing, unavoidable outlays and contributions towards the reserve fund qualify for exemption or preferential tax treatment. But, even admitting the above argument, the benefit of a lower tax burden should only be granted to that portion of labor incomes which is required to form the reserve fund, not to the taxpayer's total income from labor, irrespective of the level of the latter.

It also follows that the preferential treatment on labor incomes can technically be accommodated more appropriately, within a global tax system, through a specific allowance for earned income than through a lower flat rate in the relevant category of the schedular tax system. The first approach acknowledges the level of overall income and of the capacity for saving, whereas the latter procedure does not.

### Other arguments for qualitative discrimination

Other arguments are also held in support of qualitative discrimination.[4] Thus it is claimed that the earner of income is exposed to more costs of production than the "capitalist" who "lives on his rents". Costs must be incurred to build op professional skills or, in the contemporary parlance of economists, "human capital" must be accumulated before one actually earns income from labor. It is also stressed that labor, although a deep-seated vector of man's creativity, involves effort and toil, whereas the clipping of coupons is a painless act. To obtain earnings from labor, one must exert eight or more hours of work, whereas capital produces a yield "while one sleeps".

Those arguments in favor of labor incomes do not cut much ice, either. Truly, educational costs are involved to build up skills, but, as the Meade Report observes, if one follows that line one should also hold taxable the "rents" and "capital gains" out of improved "human capital".[5]

The reference to the painful character of labor could be construed in welfare-theoretic terms. The person who lives on capital incomes can indulge in leisure, an untaxed component of welfare, whereas leisure is incompatible with the exertion of labor; the lower tax burden on labor income would then somewhat offset the impossibility to enjoy leisure. One must remark, however, that most people probably would prefer activity over permanent idleness; human beings yearn for life's blessings, but are also moved by creative urges.

Is there then no argument that gives sufficiently strong backing to the "qualitative discrimination" theory? And how can one account for the fact that, despite the weak reasons traditionally submitted in support of that doctrine, almost all actual systems, in one way or another, impose capital incomes more stringently than earnings from labor? [6] It would seem to us that a fairly strong case can be constructed along the following lines. First, usually, income from capital is complementary to earnings from labor inputs; few are the people — if one excepts retired ones benefiting from official or private pension plans — who can afford to live without working; the more basic needs of households can, in most cases, be met by the incomes from labor; purchasing power derived from capital assets would then create scope for spending on less essential goods and services. Also, wealth begets income which in turn allows wealth to accumulate. And, apart from income, wealth undoubtedly provides a supplementary yardstick of (subjective) "capacity-to-pay" (taxes). As a matter of fact, if two persons obtain $ 50,000 per year from labor and capital, respectively, the latter is clearly better off; besides enjoying the income flow, he maintains a store of value. Wealth also affords prestige and status; it allows better access to credit facilities. Finally, one must not overlook that wealth typically is not held by widows of little means. Available data on, for example, the United States and France, show that the ownership of shares, and to a lesser extent of bonds and real estate, is heavily concentrated in the upper-income ranges of the income pyramid. It follows that when capital incomes are systematically discriminated against in schedular systems of income taxation, one approximates, albeit in a rough fashion, the vertical interpersonal distribution of tax burdens, which is intended in global-type systems and which subjects income-rich(er) persons to a higher average tax burden than their poor(er) countrymen. The argument, clearly, also has ethical overtones; in this connection, we may notice that the expressions "earned" and "unearned" (incomes) stand for "funded" and "unfunded" incomes, and carry the connotation of respectively "meritorous" and "undeserved".[7]

Those considerations give support to the case for treating incomes from labor more leniently than those from capital. But they do not postulate that income from capital be discriminated against by way of specific tax schedules, carrying different flat rates. Besides, the schedular approach to qualitative discrimination runs into a host of practical difficulties. Capital and, even more, labor are not homogeneous categories of income, neither in developed nor in low-income economies. Hence, more sub-schedules would be required to differ-

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4. We have refrained from discussing the argument based on the so-called "double taxation of savings", first as a component of income and, subsequently, when the investment produces a yield. This question has, since J. Stuart Mill, been part of the "qualitative discrimination" issue and has provoked an inordinate amount of learned controversy. The topic, however, is not relevant to our study. The thesis, if accepted, would posit preferential treatment of incomes from capital; it can be adduced as an argument for a tax on expenditures but there is now general recognition that, within the income tax, the yield from the investment is a new income item whose taxability cannot be questioned.
5. "The Structure and Reform of Direct Taxation *(Meade Report*, 1978), p. 39.
6. The higher burden on income from capital as compared to labor earnings in an equal amount is attributable not only to (a) differentiated flat rates, (b) allowances for earned income or surcharges on income from capital, and (c) a separate tax on net wealth but also to the corporate profits tax, the existence of which, alongside an individual income tax, involves an extra burden on income from capital.
7. Marxist views, alleging that the capitalist's income is exploitative and, hence, is undeserved as it appropriates "Mehrwert", produced by the workers, may have contributed towards shaping the connotation of undeservedness of capital income.

entiate between skilled and unskilled labor; self-employed and "other"-employed persons; dividends and interest. Several of those distinctions are actually to be found in schedular tax statutes. Furthermore, the category of business profits presents rather stubborn problems. Especially in family-type, small enterprises, inputs of labor and capital by the same persons are intimately intertwined. Procedures such as those used in Morocco, whereby, for purposes of applying the schedular tax on business profits, a first slice of income is deemed to be derived from labor and is subjected to a comparatively low rate, remain rather rough artifices. Especially in segmented low-income economies, the capital-labor ratios may differ dramatically between, for example, the traditional handloom and the modern textile mill; in strict adherence to the principles of the schedular system, these two classes of business should receive a different tax treatment. Finally, there is no scientifically convincing yardstick which determines to what exact degree capital income should be taxed more severely than earnings from labor of some amount, or, in other words, by how much the flat rate on capital incomes should exceed that on earnings from labor.

In sum, the case for a schedular system, predicated upon the "qualitative discrimination" doctrine, is — or more exactly, has become — particularly weak, especially as far as developed countries are concerned. The basic idea which underpins the "qualitative discrimination" theory, viz., that labor incomes ought to be burdened less, has, however, remained politically forceful. But to implement such a principle, it appears by far preferable to take into account not only the nature of incomes, but also the level of total income; this would advocate the granting of an allowance for earned incomes within global systems. Furthermore, wealth, besides income, provides an additional yardstick of taxable capacity. It follows that a net wealth tax is an appropriate way of reaching the taxable capacity embodied in wealth. In countries where this type of tax is politically not feasible or would not be efficiently implemented, such discrimination against capital incomes as exists in income tax systems may function as a second-best substitute for a net wealth tax.

We reached a rather negative conclusion about the suitability of the schedular system to "qualitatively discriminate" between capital and labor incomes. Besides, the underlying theory clearly cannot possibly provide the only criterion for apportioning the tax load. More specifically it appears advisable to account for the relative levels of total income. Our findings, however, should, at this juncture, not be interpreted as a wholesale indictment of any schedular approach to income taxation. Conceivably, rate discriminations between various categories of income may be consonant with acceptable or advisable tax principles, other than the "qualitative discrimination" doctrine.

## IV. THE ABILITY-TO-PAY CRITERION AND THE PROGRESSIVITY ISSUE

The criterion which states that each taxpaying unit must contribute to the goverment's purse in accordance with its relative capacity or ability-to-pay (taxes) has become solidly entranched in tax practice and in tax philosophy. It is also generally claimed that, in order to modulate the interpersonal income tax burden, according to the ability-to-pay, a progressive rate formula is in order. Although the arguments in favor of progressivity remain intellectually somewhat weak and although the issue is readily contaminated by explicit and implicit value judgements, the progressivity tenet apparently no longer evokes strong opposition.[8] Political ideologies have greatly contributed towards the acceptance of the progressivity principle. Socialist parties view progressive taxation as a major instrument of social policy; but also middle-of-the-road parties appear widely to accept moderately-redistributive income taxes as a method for correcting the ("primary") income distribution, resulting from the market processes.

The "ability-to-pay" canon and what looks like its natural companion, viz., the technique of progressive rates, has generated a considerable amount of writing and discussion. We do not intend to rehearse the debate at length, but limit ourselves to highlighting the major facets.

### A. Ability-to-pay

In the income tax, the "capacity-to-pay" (such tax) must be related to income. The tax statute must determine which amount and level of income can be considered as representing such ability. In modern income taxes, capacity to pay can be equated with what the Carter Commission in Canada has called "discretionary income", which is viewed as the true expression of the taxpayer's economic power.[9] Not only is the income tax duly based on a net concept and are production costs subtracted from gross income; but, there are also some (first) slices of income which are necessarily earmarked for non-compressible expenses, and which allow the taxpayer to subsist. Accordingly, modern income tax systems grant the deductibility of a personal allowance; they also account, through dependent's allowances, for the size of households. A bachelor has only himself, but the breadwinner of a family of six children has not less than eight mouths to feed. Such statutory provisions "personalize" the income tax, in that they adjust tax liabilities to differential personal circumstances; they can also be viewed as applying the canon of "horizontal equity".

#### Horizontal equity

Such personalization does not at all guarantee that the statutory allowances accurately reflect the actual outlays, which, say, the average taxpayer incurs in taking

8. In *Theorie und Praxis der modernen Einkommensbesteuerung* (Bern, 1947), pp. 71-73, F. Neumark documents how, in the 19th century, the progressivity criterion was strongly opposed in many circles. It would seem that this is no longer the case, nowadays, in low-income countries.

9. See the so-called *Carter Report*, "Report of the Royal Commission on Taxation", vol. III, Ottawa, 1966.

care of himself or his dependents. On the level of principles, the issue arises whether the allowances should reflect a physiological minimum level or a more generous amount of expenditures, which is in line with prevailing socio-economic standards of living. The exact amount of the allowance tends to be determined largely by revenue considerations and political expediency. One must remember that whenever progressive rates apply, such allowances result in the rich man saving more tax dollars than his poorer counterpart. Finally, as Musgrave remarks, income is viewed here as the only indicator of taxpaying capacity. This can be challenged. We mentioned already that wealth also embodies capacity to pay taxes. Furthermore, leisure, which goes untaxed, is also a vector of welfare.[10]

## B. Progressivity

The "ability-to-pay" principle holds that a person A with ample "discretionary income" should bear more tax than his neighbor B with less scope for compressible outlays. But one must also state to what extent the "rich" person should pay more tax than the "poorer" man. Should the amputation of taxable, discretionary income involve the same amount of dollars? Or the same proportion of taxable income? Or, a higher proportion as income rises? The first two solutions, the regressive and even the proportional ones, are nowadays generally rejected. Prevailing tax philosophy favors the application of progressive formulae to income.

### Sacrifice theories

The justification for progressive rates on income has traditionally been cast in terms of "sacrifice theories", which, in essence, apply the marginal utility theory to income and taxation. Additional units of income, it is claimed, afford less utility; or, in other words, as income rises, its marginal utility declines. Proportional rates, applied to discretionary income, would imply that rich men would sacrifice a smaller proportion of their utility than the poor men. Some have argued that the sacrifice lost through the tax should be equal; other authors, more numerous, have contended that fiscal sacrifice should be proportional to the total utility embodied in the taxpayer's (discretionary) income. Depending on the shape of the curve which portrays the declining marginal utility of income, the resulting interpersonal distribution of the tax burden, measured in units of money surrendered by the taxpayer, will be progressive, proportional or even regresssive. However, under the equi-proportional sacrifice standard it is most likely to be progressive.[11]

And yet, the case for progressive taxation has remained "uneasy".[12] On the theoretical level, the sacrifice theories suffer from several weaknesses and lack analytical rigor. First, the search for the proper version of the sacrifice standard readily escalates into the so-called "minimum aggregate sacrifice" version; lopping off, through confiscatory 100 percent marginal rates, income above a certain level would equalize the marginal utilities of all taxpayers; and overall tax sacrifice would be minimized. The concern for an equitable distribution of the tax burdens, then, makes room for the maximization of welfare in society.

But not even the most egalatarian government would dare to redistribute income in such a drastic way, which would no doubt have disastrous effects on the willingness to produce income. Besides, the sacrifice theories assume that utility can be measured in terms of cardinal quantities and that the utility curves of taxpayers are the same. Modern welfare economics holds that neither such cardinal measurement nor meaningful interpersonal comparisons of utility is intellectually acceptable, apart from their utter impracticability. Third, one may wonder whether, once more basic needs have been fulfilled, the utility curve further declines regularly; taxpayers at income levels well above subsistence may not at all perceive their additional outlay as bearing on futile luxuries. In dynamic economies, new wants are constantly being created and social groups and income classes tend to imitate the aspirations and consumption patterns of more affluent groups.

Viewed as theoretical propositions, sacrifice theories are now discredited. But it would be unwise to negate their strong appeal, ethically, politically and, one should add, also in economic terms. The impressive array of critiques against sacrifice theories cannot erase the essential truth embodied in marginal utility theory that the marginal dollar is objectively more useful for the "poor" man than for the "rich" man, as the former will thereby be able to buy more essentials and "basic" goods and services than the latter. This ethical standard emerges clearly when extremes in the income pyramid are compared; as a matter of fact, it would hurt normal sentiments of justice if the pauper were obliged to contribute the same proportion of his income as the Croesus. Besides, the impossibility of interpersonal comparisons of the utility of incomes and of the disutility of taxes, though valid in theory, should not be carried too far. Income tax legislation, as any other enforceable law, cannot be completely tailored to the individual utility profiles and whimsies of all members of society. Laws are applicable to all members or to broadly-defined subgroups of society. The law has to abstract largely from individual characteristics and idiosyncrasies. Pushed to its logical extreme conclusions, the thesis that each individual being has different perceptions of utility postulates that tax liabilities would have to be "individualized", not according to measurable units of money but of individual utility curves.

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10. See R.A. Musgrave, *The Future of Fiscal Policy. A Reassessment*, Prof. G. Eyskens Lectures, Leuven, 1978, p. 10.
11. For an excellent analysis of the sacrifice literature one may consult, besides Blum and Kalven's *The Uneasy Case for Progressive Taxation* (Chicago and London, 1953), R. Musgrave, *A Theory of Public Finance* (McGraw-Hill, New York-Toronto-London, 1959), chapter VIII, and R. Musgrave and A. Peacock, (eds.) *Classics in the Theory of Public Finance* (McMillan-St Martins Press, London-New York, 1967), pp. IX-XIX.
12. See Blum and Kalven, op. cit.

Considering the theoretical inadequacy of subjective sacrifice theories, a justification or at least an explanation of the progressivity principle has been advanced along other lines. Two decades ago, Groves already noticed the evaluation "towards a social theory of progressivity".[13] Nowadays, most authors basically accept the same view, perhaps more out of despair than conviction. Progressivity, it is claimed, has become widely established as a primary feature in income tax systems because governments and prevailing public opinion in modern societies do not accept as immutable the "primary" distribution of income which emerges from the production process. Tax systems, and particularly income taxes, should be instrumental in vertically redistributing income, by taking away a larger percentage of discretionary income as one moves up the income pyramid scale (subject, somewhere near the apex of that pyramid, to a maximum permissible marginal or/and average rate). The resulting "secondary" redistribution of income represents a step toward that distributional pattern of incomes after taxes which society perceives as optimal. On the theoretical level, reference is often made to a "social welfare function". In the words of Musgrave, "social utilities are assigned to income dollars and optimal tax patterns (or transfer patterns) may be determined on that basis".[14]

This approach, no doubt, reflects reality. It poses the issue of tax formulae and of redistributive aims and effects, essentially in political terms. But it remains vulnerable to serious objections. First, who decides about the social welfare function? The political majority, as elected through democratic "public choice" mechanisms? Or dictators who are usually repressive and only seldom benevolent? Or is this social welfare function to be viewed in the additive sense, i.e. as the aggregation of individual welfare functions, a conception which regains favor with many welfare economists. But how to trace the concrete shape of the progressivity formulae? Such statements as the progressivity slope adopted is the one which society seem to prefer risk being no more than tautological.

A supplementary equity argument in support of progressivity in income taxation is that regressive or proportional distributional features in other types of taxes can thereby be offset, to some extent. Income taxes, or even the tax system as a whole, are not the only channels through which the budget redistributes income. In this respect, in developed countries, in recent years, other conduits have attracted more attention. Social security contributions and subsidies, the inverse of taxes, must also be taken into account. The very fact that, as Okun remarks, in developed countries state budgets nowadays consist predominantly of transfer payments has greatly enlarged the redistributive potential of budget policy.[15] Besides, one should also heed the distributional effects of non-transfer budget expenditures, which are nowadays encompassed in the concept of "tertiary" (re)distribution.

## V. REDISTRIBUTION AND (UN)EQUALITY

In this section, we have no intention whatsoever to cover at length the complex problems of the measurement of the economic effects and ideological values connected with the distribution of income and wealth. We select a few comments which are relevant to our enquiry. We first draw attention to some implications that follow from the mechanics of progressive and flat rates. Besides, we wonder whether and in what ways the redistribution of income through the income tax instrument presents different features in low-income as compared to high-income countries. And finally, we indicate that, to a large extent, the "horizontal" functional distribution of tax burdens, which is inherent in the set of flat rates of rational schedular systems, may approximate the "vertical" interpersonal redistributive effects that are achieved through openly progressive formulae in global-type systems. Throughout this section, we further assume that both types of income taxation are implemented in strict adherence to the normative canons of tax-burden distribution discussed in the previous sections. This assumption will be relaxed in section VII to allow for the many structural "imperfections" which characterize empirical systems of income taxation. We should also stress that the expression "redistribution" only refers to the tax ledger of the budget. Reducing the incomes of the rich does not, in itself, improve the position of the poor, in absolute terms. If all revenue collected from the rich were spent to their exclusive benefit, the budget process would not exert any redistributive effect whatsoever.

### A. Implications of proportional and progressive rate formulae

It is sometimes overlooked that a proportional rate does have redistributive effects if one looks at the *absolute* distance or "gap" between the "richer" and the "poorer' income recipient within a given schedule or with respect to overall income. A 40 percent flat rate which applies to taxable incomes of respectively US$ 50,000 and US$ 10,000 reduces the after tax, or "disposable", incomes to respectively US$ 30,000 and US$ 6,000. Thus, the gap, in absolute terms, had been substantially narrowed from US$ 40,000 to US$ 24,000. However, under the proportional tax the *relative* distance is unaffected; in our example the post-tax ratio between the incomes of the two taxpayers remains identical to the pre-tax ratio, at 5:1. Progressive taxes, on the contrary, also reduce the relative gap or ratio. If, in our example, the two incomes are subjected to respectively 40 percent and 20 percent, the tax bite would have narrowed the absolute gap to US$ 22,000 and reduced the relative ratio from 5:1 to 3.75:1.

Whether narrowing only the absolute gap or also the relative gap should be the proper principle in pursuing a redistributive policy is a rather involved question which

13. H. Groves, "Towards a Social Theory of Progressive Taxation", *National Tax Journal*, March 1956.
14. See R.A. Musgrave, G. Eyskens Lectures, op. cit. p. 61.
15. See A.M. Okun, *Equality and Efficiency, the big Trade-off*, The Godkin Lectures, The Brookings Institution, 1975, pp. 101-2.

cannot be kept uncontaminated by value judgements about the fair or optimal state of distribution of income and wealth in a given society. One may contend that one should not go beyond the reduction of substantial absolute gaps in income even if the relative ratio remains constant; in this way socially unacceptable discrepancies in living standards and consumption patterns would already be remedied. But, as already mentioned, modern income tax systems are more maximalist and aim at narrowing the relative gap, by way of progressive rates. Observation of actual social life clearly shows that individuals and social groups are concerned about their relative position, which they are eager to improve. This is evidenced by the fact that in democratic high-income countries, some redistribution of income positions is typically part of government programs, while the same aim figures prominently in the development plans of low-income countries. In both cases, the emphasis upon the principle is often matched by lack of specification as regards the degree of redistribution sought. Consumption patterns of richer households tend to be envied and emulated by people at somewhat lower levels of living when the latter have become exposed to a "demonstration effect". Thus, relative positions and the connected issue of redistribution clearly matter.

It is also worthwhile to point to what we may call the "amplification" effect, which is inherent in the mechanics of progressive rates. When the base of taxable income expands under a progressive rate formula, the average tax liability rises as the additional income is subjected to a marginal rate that exceeds the average one. The converse is equally true: a reduction of the effectively taxed base reduces the average tax burden. We may call this the "split-effect".[16] It also follows that if an allowance of a fixed amount is granted, the tax bill of the rich person will be reduced more, in absolute amounts, than that of the poorer person (whether the relative ratio will shrink depends on the actual figures and parameters involved). Accordingly, taxpayers have an interest in attempting to split the base of taxable income. As a matter of fact, the average tax rate on twice US$ 10,000 may be substantially less than on US$ 20,000.

It also follows that nominal rates may be highly misleading when gauging the real effects of redistributive taxation. Exemptions, deductions and allowances tend to considerably reduce the effective average rate to much lower levels than the nominal average rate would lead us to believe — abstracting even from evasion and avoidance. The effective rate is then calculated with reference to a level of income which, in the light of accepted tax standards, should constitute the taxable base. Hence, there exists a conflict between such "tax breaks" and the aim of secondary redistribution through the tax medium. Contrary to frequent assertions, however, no undesirable erosive effects can be attributed to personal allowances and the like, which are meant to refine the concept of "ability-to-pay" (as represented by "discretionary income") since progressive formulae should be applied on "discretionary income" and not on "net (produced) income".

## B. Tentative thoughts about the scope for redistribution in high-income and low-income countries

We should briefly draw attention to a paradox in most countries of the Western world. Their societies have reached an unprecedented level of affluence; comparatively few people can be said to be poor, even if the poverty line is drawn well above a physiological minimum income level; furthermore, those poor are not a homogeneous social group but are scattered over various segments of the population.[17] Thus, one might have expected that the issue of the relative income gaps would come to rest and that there would be few claims to reduce that distance. And yet, the relative dimension draws attention not only in academic circles but, even more, on the political level. Various political parties and trade unions want to reduce the income spectrum to low multiples, mainly by way of narrowing the wage differentials, or, in other words, through intervention in the primary distribution. Well-organized social and pressure groups strive to improve their position: the claims are frequently predicated on references to other groups who are perceived to be in a better but

**A paradox: in rich countries a tendency to equalize incomes**

undeserved position. Hirsch has addressed himself to the above-mentioned paradox which he attributes to the increasing scarcity of "positional goods" (such as vacations on non-crowded beaches), as "the vast increase in material productivity has pushed the frontier of mass demand into terrain where there is no longer more for all".[18] Scitovsky has also found "rankhappiness" to be relevant to present affluent societies.[19] Whether the strong urge for further redistribution will be a lasting phenomenon or, on the contrary, is symptomatic of a recessionary period cannot easily be prognosticated. Some pointers, such as the growing awareness of the disincentive effects of high tax burdens and even some overt signs of tax revolt, suggest that redistributive policies, particularly through the tax medium, may be widely looked upon with disfavor before long.

In the typical low-income country, the situation is utterly different. Two series of remarks are to the point. First, income inequality is probably in most cases

16. The expression "split" is used here in a general sense, whereas in the tax literature it tends to refer specifically to the treatment of the incomes of spouses.

17. See, for example, P. Taubman, *Income Distribution and Redistribution* (Addison-Wesley, 1978), pp. 22-25. The official poverty line in the U.S.A. is defined as three times an emergency food level and stood at US$ 5,000 in 1974, for an urban family of four. The incidence rate of absolute poverty had declined from 33 percent of the population in the late 1940s to about 11.5 percent today.

18. F. Hirsch, *Social Limits to Growth* (Routledge and Kegan, 1977). The excerpt is on p. 117.

19. T. Scitovsky, *The Joyless Economy. An Inquiry into Human Satisfaction and Consumer Dissatisfaction* (Oxford University Press, 1977), especially chapter VII.

somewhat more pronounced than in present-day affluent societies.[20] Notice a number of qualifications, however. The statistical data are generally of poor quality and cross-sectional comparisons, between countries, require great caution. Much depends on the underlying distribution of assets and of skills, indeed on the social structure, itself. For example, in Latin American countries, with their latifundia[21] the overall inequality is likely to be greater than where, as in South Asia, ownership of land is already highly fragmented. On the whole, economists tend to recognize the "Kuznetz effect", which holds that, in the early stages of growth, inequality widens. There also does not seem to be a clear relationship between the growth rate and the degree and the trend in inequality; much depends on the actual policies followed.[22]

Another feature dominates the profile of income distribution in low-income countries, namely, the widespread occurrence of absolute poverty.[23] In most developing agricultural occupations, the absolutely poor are found predominantly in the rural sector. Even people who, in a vertical-income pyramid, would be situated well above the, say, lowest two deciles do not exhibit any or very little taxable capacity, although they may be three times "better off" than the poorest people. In other words, the connotation of income, well above a minimum, poverty level, which accompanies the expression "middle classes", as used within the context of high-income countries, is not relevant in poor developing countries.

The basic point to be made is that, with respect to such matters as fiscal redistribution and (income) tax policy, the absolute or cardinal dimension of the pattern of income distribution cannot be overlooked. Consequently, the coverage of the income tax in low-income countries tends to be limited to the higher-income ranks and to the modern sector. "The income tax is a class not a mass tax" as the saying goes. Moreover, as in numerous (but not all) low-income countries, the upper strata of taxpayers enjoy a standard of living which is comparable to that of the top-ranked taxpayers in developed countries, steeply progressive taxes would shave off relatively more income than in a developed country. But, again, in countries in which no large "middle class" has yet developed, siphoning off income from the comparatively few "absolutely rich" would yield only little revenue, which, even if spent in favor of the large numbers of the absolutely poor, would only marginally improve the individual lot of the latter. In developed countries, on the contrary, fiscal redistribution is partly made possible because middle classes form the bulk of the population and are subjected to progressive income taxation. The income tax must also be expected to be a relatively less productive generator of revenue than in rich countries; this is confirmed by the actual data.

## C. Redistribution in schedular and global tax systems

Assuming that some degrees of redistribution should be achieved, or at least attempted, through the income tax medium, our specific question now is whether such an objective can be reached more easily within schedular or global systems of income taxation, of equal yield and otherwise equal circumstances, by virtue of the distributional formulae which are found in the schedular or global types.

Conclusions with respect to the redistributive impact exerted by flat rates, differentiated per schedule in the schedular system, and progressive rates in global systems are already foreshadowed in the previous analysis. Obviously, progressive rates reduce not only the absolute but also the relative gap between taxpayers at different levels of the income pyramid. Within each category of the schedular tax, a flat rate narrows the distance, in absolute terms, but leaves the relative ratio constant.

As has been clearly established, different levels of overall income involve differences in the compositions of income. Generally speaking the share of income from capital in total income increases when one moves upwards along the income pyramid. This is particularly true with respect to the top-layer incomes, which are most often derived largely from capital assets. Capital assets are usually found to be more unequally distributed than incomes.[24] This holds for developed countries, but also, and perhaps even more, for most low-income countries, although the nature of the income-generating assets will differ, with land holdings being comparatively more important than financial assets. Conversely, and on the same grounds, the progressive rate formula on global income contains a built-in qualitative discrimination against capital incomes, even when the tax statute does not openly specify any such discrimination.

This similarity of redistributive and discriminatory effects, however, is a very crude and an imperfect one. When one looks, statistically, at large numbers, one finds that as income rises, it will tend to be composed relatively more of income from capital. But there are bound to be many deviations of individual cases vis-à-vis such general correlation. To apply the same general rule to such deviating cases would result in unfair treatment. The widow, living on her meager savings, would be taxed at the same flat rate as the rich "capitalist", in the schedular system. Besides, there are many types of capital assets, and their degree of concentration in

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20. See the tabulation for a large group of countries in H.B. Chenery et al., *Redistribution with Growth* (Oxford University Press, 1974), p. 8-9.

21. Or large estates, owned by absentee landowners.

22. See S. Kuznets, "Quantitative Aspects of the Economic Growth of Nations: VIII. Distribution of Income by Size", *Economic Development and Cultural Change*, vol. XI, No. 2, part II, January 1963.

23. See D. Morawetz, "Twenty-five Years of Economic Development: 1950 to 1975", The World Bank, 1977, p. 41. The absolute poverty line for the "destitute" was put in the ILO publication *Employment, Growth and Basic Needs. A One World Problem* (Geneva, 1976) at respectively US$ 90 in Latin America, US$ 59 in Africa and US$ 50 in Asia. 39 percent of the population of the developing market economies were estimated to belong to that category of "destitute" and 67 percent to a broader category of "seriously poor". See p. 22.

24. See, for example, A.M. Okun, op.cit., p. 66.

high-income brackets is dissimilar; the ownership of government bonds, for example, is known to be broader than that of shares. The schedular system would also imply the same flat rate on the income derived from or attributed to the tiny parcels of land held by the minifundista and to the large estates of the latifundista.

In sum, the object-centered system of schedular taxes, which are predicated on the functional distribution of income, can only inadequately perform the role of a redistributive progressive tax, which is meant to influence the personal distribution of income. The converse does not equally hold. As explained in section III, in progressive systems, allowances, which discriminate in favor of labor incomes, can be inserted. They appear to be even more appropriate techniques than the open rate-discrimination which characterizes the schedular approach to income taxation.

**Which system is better?**
**Global income taxes or schedular schemes?**

Should one then conclude, without any reservation, that global income taxes score better than schedular schemes? As a matter of fact, the former allow taxpayers to be subject to progressively distributed tax burdens, in function of the ability-to-pay of each taxpayer and, furthermore, also permit some "hidden" application of the qualitative discrimination principle, to the extent such a canon is deemed relevant. It would seem, indeed, that the above conclusion is warranted; provided, however, that the progressive income tax on global income is implemented in a consistent and effective way. If large components of overall income which, according to basic principles, should be effectively taxed remain outside the tax net, for whatever reason, the logic of the progressivity technique is perverted and its applications eroded and distorted. Let us suppose, in a rather extreme example, that almost all incomes from capital are escaping tax, either as a result of statutory exemptions or because such incomes are not reported. Rich taxpayers would then benefit in a double way: first, because capital incomes are concentrated in high-income echelons; and, second, because, as explained earlier, the non-taxation of a slice of income results in a larger "split effect" or tax savings (in absolute terms) for the rich than for the poor taxpayers. One may conclude that global systems, endowed with progressive rate formulae, are exacting systems, in that they require both a consistent tax design and a tight implementation. Any statutory exceptions to the ability-to-pay principle should be fully justified and the tax should be administered without major leakages and underreporting. Otherwise, the use of progressive rate formulae results in gross inequities and in a parody of sound tax principles. The nominal rates may create the illusion of an equitable and even of a severely redistributive system,[25] but, upon inspection, the distribution of *effective* tax burdens may tell a quite different story.

## VI. INCOMPATIBILITY OF PROGRESSIVE RATE FORMULAE WITH SCHEDULAR SYSTEMS

We just concluded that the differentiation in the flat rates within the schedular system is at best a hidden and an imperfect substitute for openly progressive rates — but that the latter call for highly-effective tax administration. The question then arises whether the insertion of progressive rates in schedular systems — about which some authors have hypothesized that it is an easier system to administer — could provide an optimal or, at least, a "satisfactory" solution. In other words, could progressive rate formulae in schedular systems apportion taxes according to the ability-to-pay standard?

As a matter of fact, in historical schedular systems and in the more frequent schedular layers of mixed systems, the category of labor income typically contains elements of progressivity. In a number of countries, especially in Latin America, the schedule which lists the profits of corporations or of enterprises (when no separate corporation tax exists) carries progressive taxes.[26] Other less familiar cases of graduated rates, as on rental incomes in Zaire, can be cited. One could also visualize that, as an indirect instrument of land reform, the rates on income from land would be progressive — although graduated taxes on land property which do not penalize the diligent farmer may be more appropriate to that end.

One can easily demonstrate that the aim of apportioning the income tax burden according to the capacity-to-pay principle can only be achieved within a schedular framework in a consistent way and without distortive effects, provided two conditions are fulfilled, viz. (a) that each taxpayer would only obtain income from a single source, *and* (b) that the formula of progressive rates would be identical in all schedules.

The extent to which taxpaying units obtain income from different sources is essentially an empirical question. Table I contains some data about the U.S.A. and Brazil. The table does not convey a direct frequency distribution of taxpayers, in terms of multi-source income; yet, a comparison of the numbers of salaried and self-employed, as compared to those with other incomes, indirectly provides insights into the occurrence of multiple-source incomes. Earnings from labor may be considered as "core" incomes as most people, in good health and of working age, want to be gainfully active and to employ their "human" capital.

25. The astronomically high top marginal rates, up to, say, 90 percent which are featured in some tax statutes should not create too many illusions, except that they may make believe that the country pursues a vigorous redistributive policy. It may well be that no taxpayer whatsoever is subject to such a confiscatory rate.

26. One tally reveals that, out of 18 Latin American countries, 12 had an extended set of progressive rates on corporate profits. See G.E. Lent, "La politica tributaria en cuanto determinante de la combinación optima de los factores capital y trabajo", in *Reforma tributaria para América Latina. IV La Política tributaria como instrumento del desarrollo*, Organización de los Estados Americanos, Washington D.C., 1973, pp. 328-29.

## TABLE I

**Number of "schedular entries" in global income tax returns in the U.S.A. and Brazil: 1976 incomes (in millions)**

| | *United States* | *Brazil* |
|---|---|---|
| Comp. Population | 215.1 | 110.0 |
| *Overall Number of Returns (in '000)* | 84.7 | 5.2 |
| of which – taxable | 64.4 | 0.9 |
| – non-taxable | 20.2 | 1.9 |
| of which – simplified forms | 28.6 | 1.6 |
| – full forms | 56.1 | 4.1 |
| *Number of Returns with Income from Designated Sources* | | |
| salaries and wages (gross) | 75.5 | 1.53 |
| business (*) and professions (**) | | 0.29(*) |
| – net profit | 5.7 | 0.86(**) |
| – net loss | 1.8 | |
| farm | | 0.39 |
| – net profit | 1.3 | |
| – net loss | 1.5 | |
| partnership (net) | 2.6 | |
| sales of capital assets | | |
| – capital gains | 6.1 | |
| – capital losses | 2.4 | |
| dividends | 9.0 | |
| interests | 42.6 | |
| pensions | 5.6 | |
| rents | | 0.69 |
| – net income | 3.9 | |
| – net loss | 2.9 | |
| royalties (net) | 0.6 | 0.17 |

*Source:* Internal Revenue Service, Statistics of Income 1976, Individual Income Tax Returns/Annuario economico-fiscal de 1977, Ministerio da fazenda, Secretaria de Receita federal.

On a priori grounds and in the light of the available evidence, one should not overrate the proportion of taxpayers who derive taxable income from more than one source. Incidentally, the fact that a great many taxpayers only derive income from one (labor) source explains why many countries allow a simplified return: dependent labor incomes can be easily taxed at the source; no subsequent adjustments are required when no other taxable income accrues to the taxpayer. The important point, however, is that multiple incomes can be expected to occur more frequently in higher-income echelons, where wealth is known to be concentrated.

Both Brazil and the United States have a global tax system. The statistics detail the entries for each of the different incomes which have been recorded in the returns. One first notices the enormous difference in coverage, i.e. in the ratio of returns to the total population, which works out respectively at 39.4 percent for the U.S.A. and 4.5 percent for Brazil, although Brazil is distinctly a middle-income developing country, with a per capita income of US$ 1,140 in 1976. The number of returns reporting income from agricultural activities is very low in Brazil, although a large proportion of the population poorly lives on farms. This factor may largely explain the low ratio of returns. In both countries, the possibility exists for specified taxpayers — particularly those with only labor income — to file a simplified form.

Comparing the number of "schedular entries", i.e. of different types of income declared, to the number of returns which contain "core" incomes (i.e. from labor, both salaried and self-employed) one finds a ratio of 2.13 in the U.S.A. For Brazil, and looking only at the data for those who file a full report, the ratio stands at 1.47. One should not infer too much from the difference in the ratio as an accurate comparison is difficult, for various reasons. It would appear, however, that even in a developing country, those who must file a return frequently have more than one income source. This comes as no surprise if one recalls that the coverage of the income tax tends to be restricted to those who are comparatively well-off in the modern sector and that wealth and income tend to be more concentrated in developing than in developed countries.

One must expect the number of taxpayers with multi-source income to increase, when: per capita income rises, as whenever essential and non-compressible consumption needs are fulfilled, there is scope for savings; financial investment grows, thus engendering additional income. The extent to which the frequency of multiple incomes shows up in the statistics depends largely on specific arrangements in the actual tax statutes.

Thus, the absolute and relative number of taxpayers with more than one income will increase when:
— imputed rents on owner-occupied homes are held taxable;
— the household is viewed as the proper taxable unit and more persons in the household obtain taxable income. Recent years have witnessed, in Western Europe and in the United States, a growing number of married wives entering into the salaried work force;
— the tax administration becomes more efficient as when, for example, the beneficiaries of income from securities, which are taxed at the source, can be identified;
- the tax legislator brings small incomes within the reach of the income tax. Even small incomes from savings deposits may be taxable, as in the U.S.A., whereas elsewhere they often are exempted, thus considerably reducing the number of households with taxable income from multiple sources.

A real-life illustration of the distortions which progressive rates may cause in some — not all — schedules is given in table II, which reflects the rates in the schedular layer of the mixed system in Portugal, in 1976.

The differential tax burdens for taxpayers with the same overall nominal[27] net income of 1 million Esc. are fairly substantial. Taxpayer B is 16.5 percent below and taxpayer D 18.3 percent above the average tax burden on the 1 million Esc. income. Such divergences could conceivably be rationalized on the basis of the qualitative discrimination theory; but then the higher burden on "pure" labor income, as compared with business income of "mixed" origin, is an obvious anomaly.

27. Abstracting from differential degrees of underreporting.

Technically speaking, global type tax systems could conceivable also be endowed with proportional rates. But rate formulae are no more than technical parameters which can only be called suitable in the light of the accepted standards of equity, a given society wishes to adhere to. As a progressive rate formula is viewed as an appropriate instrument to modulate tax burdens, according to the "ability-to-pay" canon — as discussed in previous sections of this paper — actual global type income taxes are equipped with progressive rates. And, as just stressed, the globalization of the taxable base is a prerequisite, if progressive rates are to be operated in a logical and consistent manner. One must add, as was analyzed in detail in a previous paper,[28] that personalizing devices, such as allowances for dependents, should also refer to overall income. If such personalizing features, which narrow the taxable base, are available in one or in several schedules, taxpayers with the same overall discretionary income would be taxed differently, depending on the source(s) and composition of their incomes.

**TABLE II**
**PORTUGAL – SCHEDULAR LAYER – 1976**

**Differential nominal tax burdens on hypothetical taxpayers with overall income of 1 mln. Esc. from different sources (in Escudos)**

| | *wages salaries* | *business profits* | *rents* | *interest dividends* | *total tax* |
|---|---|---|---|---|---|
| A. Income tax | 1,000,000<br>(220,000) | | | | 220,000 |
| B. Income tax | | 1,000,000<br>(174,000) | | | 174,000 |
| C. Income tax | | | 1,000,000<br>(240,000) | | 240,000 |
| D. Income tax | | | | 1,000,000<br>(240,400) | 240,000 |
| E. Income tax | 800,000<br>(149,600) | | 200,000<br>(31,460) | | 181,060 |
| F. Income tax | | 800,000<br>(139,200) | | 200,000<br>(49,280) | 188,480 |
| | | | | Average: | 208,357 |

*Source:* Computed from Portuguese income tax rates.

Above, we noticed that, in order to render progressive rates compatible with rational schedular systems, the same rate formula should be applied in all schedules. But, as already stressed, this condition is only relevant if taxpayers are drawing income only from one source. In the fairly substantial number of cases in which multiple incomes are enjoyed, even identical schemes of progressivity would distort tax burdens amongst taxpayers with the same overall income, but with different components. Besides, some categories of income are not amenable to the imposition of progressive taxes. Thus, the yield from securities in bearer form is often taxed at the source, in a "blind way", without the tax authorities being intent upon identifying the beneficiary; such payments occur at irregular dates and in a fragmented way. Hence, progressive rates, at the time the coupons are cashed, are not feasible. And if the withholding levy were operated as "installment" payments, to be credited against the tax liability which the taxpayer would incur on all his income from securities or on his overall income, subsequently a return would be required from the taxpayer. However, once returns are requested for incomes of one type, the door is opened to have all incomes reported in the annual declaration — a more convenient procedure both for the taxpayer and the tax administration.

## VII. FACTS VERSUS PRINCIPLES

So far, we have evaluated the wisdom of alternative canons of equitable distribution of the tax burden which provide the logical underpinnings for the schedular or global types of income taxation. We assumed, somewhat unrealistically, that the two prototypes of income taxation would be designed in strict adherence to their basic distributional canons. We should now briefly descend from the highland of principles into the valley of actual, historical tax systems. In this context, the cases in which given techniques are inserted in a given structural mold, despite the deviations and inconsistencies which they entail, should attract particular attention, as they highlight the strong appeal of particular tax principles.

One fact stands out. In schedular systems, various personalizing features have, over the years, been inserted. This is particularly the case for the "core incomes", i.e. those resulting from the productive use of human labor. Those schedules have usually, to some extent, been equipped with progressive rates; and a basic personal exemption, sometimes complemented by allowances for dependents, has been granted — despite the fact that schedular layers have mostly been capped by a complementary tax, of a global nature, which, by definition, contains a progressive formula and various personalization parameters. Some decades ago, the French author Laufenburger rightly referred to the then prevailing schedular systems as "semi-personalized" ones.[29] Furthermore, in recent years, several countries, including some in the Third World (such as Peru and Bolivia and, in a half-way fashion, Mexico), have converted their mixed systems into global types of income taxation.

Those facts suggest that the ability-to-pay principle and the redistributive aims which the progressive rate formula tends to achieve cannot be ignored, not even in a schedular system, although the latter, on account of its object-centered nature and its fragmented approach, cannot accommodate progressivity without giving rise to

28. See S. Plasschaert, "The Definition of Net Income in Schedular and Global Types of Income Taxation", *32 Bulletin for International Fiscal Documentation* 201 (1978).
29. See H. Laufenburger, in *Théorie économique et psychologique des finances publiques* (Paris, 1956), and in other publications.

inconsistencies and distortions in tax burden distribution. One should add, however, that the drawbacks associated with the insertion of progressive rates in schedular systems are greatly attenuated by the fact that a large number of taxpayers receive income from only one source, viz. from their labor inputs. Our analysis also allows the conclusion that the qualitative discrimination doctrine is theoretically not convincing and can, to the extent deemed desirable, be implemented within a global scheme without necessitating the schedular technique.

In the light of the arguments advanced earlier this conclusion would also hold in low-income countries. Admittedly, labor incomes are not given the comprehensive protection which they enjoy in the welfare state of modern developed societies. But when incomes from labor are taxed, contributions to voluntary pension reserve funds can easily be made tax-deductible. Besides, the size of taxable income is a more relevant determinant of the capacity for saving than the nature of such income. And, finally, on account of the low per capita income and the large incidence of absolute poverty the income tax covers only comparatively well-to-do classes.

It would be wrong to infer that, in historical global systems, the ability-to-pay canon and the progressivity technique are implemented in a logically consistent way. In actual fact, various portions of income, which according to the above canon would have to be taxable, do escape taxation, with the result that, owing to what we called the "split effect", the progressive distribution of tax burdens is weakened, usually resulting in higher "tax breaks" (expressed in absolute terms), for the rich than for the poorer taxpayer.

Such leakages are due to various causes, and more particularly to:

— some discriminations between classes of taxpayers which result from the way the global tax must be designed. Usually, and for good reasons, the individual income tax of global vintage is accompanied by a flat rate tax on profits of corporations. Thus, enterprises are treated differently according to their legal form;

— some portions of income, while taxable in principle, cannot effectively be taxed because of sheer administrative difficulties; or the government renounces its claims in order to avoid some undesirable side effects. For example, the definition of gross income would call for the taxation of unrealized capital gains enjoyed by individuals. But no country appears in a position to fully comprehend such accretion to economic power, and one must content itself with taxing only realized gains;

— underassessment also results from illegal evasion and its cousin, tax avoidance;

— various tax breaks, which are meant to induce the taxpayer towards the use of his income into desired channels, such as given savings instruments. Those incentives imply a transgression of the ability-to-pay benchmark.

### Global income tax superior to schedular tax

At this point, however, one important conclusion emerges from the analysis in this paper. The global type income tax appears as clearly superior to the traditional schedular systems in the light of modern equity standards, but it is an exacting method of taxing income. There should be a high degree of restraint towards granting tax favors, which erode the taxable base. If such breaks are afforded, they should have been carefully reconciled with the goals one wishes to achieve through them. Secondly, the global system calls for effective administration; here again, one should realize that administrative inadequacies, if they cannot realistically be remedied, must be weighted against the loss of equity. In both instances the resulting actual ("effective") distribution of tax burdens may deviate substantially from the intended apportionment, as expressed in the formula of nominal rates. The nominal formula may not be more than a travesty of sound equity rules which masks a large number of undesirable inequities.

# THE GROWTH AND TRENDS OF TAX REVENUES IN THE CARIBBEAN*

by Dr. Kempe R. Hope **

## INTRODUCTION

In recent times a number of articles have appeared in various international journals pertaining to the role of external borrowing and its changing composition and importance to less developed countries. This taxation article, which is a case study of the Caribbean, was written to demonstrate that, despite the growing significance of external borrowing by the Caribbean countries, the role of tax revenues is still of major importance in the development process and an important fiscal tool. This is so primarily because the nature and rate of taxation are internally controlled and, as such, not subject to developments in the international money markets which are difficult to foresee.

Taxation remains the major fiscal tool on the revenue side. It is that fact that rationally dictates that borrowing should only occur when government expenditures exceed revenues and tax revenues cannot be beneficially increased. This paper assesses the growth, trends, and possible scope of tax revenues, in the Caribbean, in the future.

## INDIRECT TAXES

First we look at the indirect taxes in the Caribbean which, as seen in Table 1, constitute the major component of total tax revenues in Guyana and Jamaica. In Jamaica, the indirect taxes have been steadily increasing while the direct taxes have been declining. In contrast, in Guyana, direct taxes have been increasing along with the increases in indirect taxes. Both in Barbados and Trinidad and Tobago the indirect taxes are not the major component of total tax revenues. During the period 1960-75, indirect taxes in Guyana and Jamaica increased significantly. The increases were a little more than 600 percent in each case during that period. After 1975, indirect taxes in both countries exhibited uneven declines.

The indirect taxes are composed primarily of production and sales taxes and international trade taxes as shown in Table 2. In all of the countries the changes in each component of the indirect taxes have been inconsistent. In Trinidad and Tobago, after 1973, trade taxes declined in importance and production and sales taxes became the major source of indirect tax revenues. The increase in production and sales taxes in Trinidad and Tobago has been due to the government's immediate response to the boom in world petroleum prices by overhauling the tax system to tap windfall profits of the petroleum companies. The government enacted a refinery tax on each barrel of oil and instituted a production levy designed to fund a domestic subsidy on petroleum products.

In Jamaica, except during 1974 and 1975, the production and sales taxes have consistently dominated the indirect taxes. The major part of Jamaica's indirect taxes is derived from the bauxite industry which provides approximately 23 percent of Central Government revenues. In 1974, the Jamaican government launched an ambitious plan to (1) increase its share in the profits of the bauxite industry, and (2) extend its control over bauxite and alumina operations. One of the results of that plan was the enactment of a bauxite levy which obliged the bauxite and alumina companies to pay a levy for all bauxite mined in Jamaica. However, since 1976, receipts from the bauxite levy have been declining considerably owing to large declines in production.

In Guyana, until 1976, the trade taxes were the major component of indirect taxes. In 1974 and 1975, there was an increase in the consumption tax revenue and windfall amounts were also collected in those same two years after the imposition of a sugar export levy in 1974. After 1976, however, the output of Guyana's three major industries — bauxite, sugar, and rice — declined considerably as a result of poor weather and labour disputes. This resulted in a decline in indirect tax revenues and in overall government revenues.

* This paper is a case study of the more developed Caribbean countries: Barbados, Guyana, Jamaica, and Trinidad and Tobago.

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## TABLE 1

### Central government tax revenues, 1960-78
(Millions of U.S. Dollars)

| Year | Barbados | | | Guyana | | | Jamaica | | | Trinidad and Tobago | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | *Direct taxes* | *Indirect taxes* | *Total tax revenue* | *Direct taxes* | *Indirect taxes* | *Total tax revenue* | *Direct taxes* | *Indirect taxes* | *Total tax revenue* | *Direct taxes* | *Indirect taxes* | *Total tax revenue* |
| 1960 | 3.8 | 9.3 | 13.1 | 11.6 | 18.9 | 30.5 | 30.9 | 58.2 | 89.1 | 34.5 | 32.9 | 67.4 |
| 1965 | 7.2 | 11.8 | 19.0 | 12.9 | 24.5 | 37.4 | 58.9 | 113.3 | 172.2 | 45.1 | 51.1 | 96.2 |
| 1970 | 13.8 | 16.7 | 30.5 | 26.3 | 33.3 | 59.6 | 67.6 | 82.4 | 150.0 | 144.3 | 130.3 | 274.6 |
| 1973 | 33.5 | 51.6 | 85.1 | 39.5 | 44.4 | 83.9 | 265.7 | 275.5 | 541.2 | 124.7 | 110.2 | 234.9 |
| 1974 | 32.4 | 29.3 | 61.7 | 37.2 | 86.2 | 123.4 | 249.4 | 416.1 | 665.5 | 287.4 | 105.9 | 393.3 |
| 1975 | 39.2 | 28.7 | 67.9 | 44.6 | 139.7 | 184.3 | 235.1 | 439.0 | 674.1 | 324.4 | 103.5 | 427.9 |
| 1976 | 46.3 | 43.0 | 89.3 | 51.8 | 93.5 | 145.3 | 230.9 | 371.1 | 602.0 | 354.9 | 123.9 | 478.8 |
| 1977 | 49.2 | 40.0 | 89.2 | 65.9 | 55.6 | 121.5 | 185.0 | 329.2 | 514.2 | 409.2 | 143.9 | 553.1 |
| 1978 | 48.4 | 41.6 | 90.0 | 59.4 | 56.2 | 115.4 | 187.6 | 469.5 | 657.1 | 425.9 | 138.3 | 564.2 |

*Sources:* Inter-American Development Bank, ***Economic and Social Progress in Latin America*** (Washington, D.C.: IDB, Several Years); and ***World Tables 1976*** (Baltimore: Johns Hopkins University Press, 1976).

## TABLE 2

### Composition of indirect tax revenues, 1970-78
(Millions of U.S. Dollars)

| Year | Barbados | | | | Guyana | | | | Jamaica | | | | Trinidad and Tobago | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | *Production and sales taxes* | *Trade taxes* | *Other[a]* | *Total* | *Production and sales taxes* | *Trade taxes* | *Other[a]* | *Total* | *Production and sales taxes* | *Trade taxes* | *Other[a]* | *Total* | *Production and sales taxes* | *Trade taxes* | *Other[a]* | *Total* |
| 1970 | 6.8 | 9.4 | 0.5 | 16.7 | 9.1 | 21.9 | 2.3 | 33.3 | 36.1 | 34.1 | 12.2 | 82.4 | 18.0 | 88.1 | 24.2 | 130.3 |
| 1971 | 9.4 | 12.2 | 0.5 | 22.1 | 10.6 | 22.4 | 2.8 | 35.8 | 81.9 | 77.6 | 32.7 | 192.2 | 10.9 | 51.1 | 12.4 | 74.4 |
| 1972 | 9.3 | 12.0 | 0.5 | 21.8 | 11.4 | 19.2 | 3.1 | 33.7 | 93.4 | 88.4 | 25.1 | 206.9 | 14.9 | 51.2 | 17.0 | 83.1 |
| 1973 | 14.1 | 19.1 | 18.4 | 51.6 | 21.2 | 21.0 | 2.2 | 44.4 | 155.6 | 93.9 | 26.0 | 275.5 | 66.5 | 36.7 | 7.0 | 110.2 |
| 1974 | 10.5 | 18.3 | 0.5 | 29.3 | 24.9 | 57.2 | 4.1 | 86.2 | 154.1 | 240.9 | 21.1 | 416.1 | 75.8 | 25.3 | 4.8 | 105.9 |
| 1975 | 13.5 | 14.6 | 0.6 | 28.7 | 25.1 | 110.5 | 4.1 | 139.7 | 170.7 | 250.7 | 17.6 | 439.0 | 70.5 | 27.9 | 5.1 | 103.5 |
| 1976 | 19.3 | 15.8 | 7.9 | 43.0 | 32.2 | 55.9 | 5.4 | 93.5 | 192.8 | 163.6 | 14.7 | 371.1 | 80.2 | 37.7 | 6.0 | 123.9 |
| 1977 | 19.4 | 20.1 | 0.5 | 40.0 | 29.3 | 21.4 | 4.9 | 55.6 | 206.3 | 108.2 | 14.7 | 329.2 | 89.8 | 46.4 | 7.7 | 143.9 |
| 1978 | 20.8 | 19.8 | 1.0 | 41.6 | 33.9 | 16.8 | 5.5 | 56.2 | 272.2 | 197.3 | 0 | 469.5 | 77.6 | 52.9 | 7.8 | 138.3 |

*Sources:* Same as for Table 1.
*a* Includes revenue from fiscal monopolies, business and professional licenses, motor vehicle registrations, and stamps.

Until 1975, Barbados' trade taxes were the major component of indirect taxes. During 1977 and 1978 the Barbadian government took a number of fiscal measures in recognition of the growing precariousness of public sector finances. This resulted in increases in the consumption tax rates on luxury goods and the enactment of an employment levy which considerably boosted government revenues.

The indirect taxes in developing countries tend to work positively, for the most part, by encouraging savings and conserving foreign exchange for the necessary import of capital goods. Such taxes also help to prevent prices from rising too rapidly when ongoing investment is increasing personal incomes faster than the output of finished goods and services is rising. These taxes are popular not only because of their administrative simplicity, but also because they can satisfy the principles of progressivity and built-in stability as well as equity. One additional property of indirect taxes of particular interest to developing countries is their ability to allocate resources to desired areas of development.

Equity is served by exempting necessities and the produce of peasant farmers from taxation while graduated taxes imposed on non-essentials and luxuries, especially if established through scientific studies of family budgets, allow indirect taxes to satisfy the principle of ability-to-pay and the built-in flexibility property. By raising the cost of consumption relative to saving, indirect taxes tend to encourage the latter at the expense of the former. In a system of indirect taxes, saving is stimulated as it virtually escapes taxation and resources are released from consumption to capital formation whose contribution to economic development cannot be overemphasised.

Indirect taxes serve the purpose of industrialisation by diverting resources to desirable activities. On the one hand, import duties graduated according to the degree of luxury of imported commodities provide incentives for domestic production. The particular stimulation given to semi-luxury or luxury goods should be dealt with carefully and their local production discouraged at times by heavy sales or excise taxes or even by outright prohibition because resources should be used for the production of more urgently needed commodities.

Indirect taxes imposed on locally produced goods are, on the other hand, designed to divert resources from the production of luxuries to semi-luxuries and necessities, by affecting the rate of return. This goal is not always easy to achieve and its attainment depends, in the final analysis, on the diversionary effect of taxes on particular commodities with different elasticities of supply and demand. If, however, indirect taxes fail to change the allocation of resources and the pattern of investment, other measures affecting relative prices and relative profitability must be employed.

The structure of indirect taxes should be such as not to stifle altogether the production of semi-luxury goods, defined as those widely consumed by people above the subsistence level, but kept at low levels as a stimulant for increased participation in the development process. The favourable tax treatment of necessities should not be taken to mean that the majority of resources released through taxation are used to expand the production of necessities. It is important that the production of necessities increase at least at the same rate as the population growth, but due to the prevailing poverty in the Caribbean, it is easy for income increases to be spent exclusively on consumption. As such, to protect the long-term development interests of the Caribbean countries, part of the increased incomes must be diverted to investment through mass commodity taxation. Indirect taxes have an important role to play in this respect by transferring resources from consumers to the public sector, which in turn uses these resources for investment. Mass commodity taxation is therefore fully justified as it serves to raise the incremental saving ratio.

Taxes are commonly classified according to the kind of action that creates the liability or the nature of the base on which the tax is levied. Taxes on goods and services may include all taxes and duties levied on production, sale, transfer, leasing, and delivery of goods and rendering of services, or in respect of taxes on the use or ownership of goods or permission to use goods or perform activities. [1]

Historically, excise taxation has been associated with domestically produced commodities. Any countervailing duty on goods coming from abroad is incorporated in the importy duty, and sales taxes are levied as general taxes on the sale of goods and services. The scope of coverage emerges as the most useful distinction between excises and sales taxes. Under an excise system, taxable commodities are individually enumerated in the law; while under a sales tax the tax base is typically defined to include all commodities for sale other than those specifically exempted. In Jamaica and Trinidad and Tobago there are no sales taxes while Barbados has a sales tax at the retail level and Guyana has a manufacturers sales tax. With respect to the excise taxes, in Barbados, Jamaica, and Trinidad and Tobago the coverage is extended which means the tax spans almost the whole range of production activities in those countries. In Guyana, the excise tax coverage is limited to specified domestically produced goods and similar goods imported from CARICOM.

While indirect taxes are inadequate, by usual standards, as sole measures of tax capacity, the traditional case for indirect taxes in the Caribbean has been made on the basis of their potential revenue yield and their administrative simplicty when compared to the income tax. It would seem though that the prevailing indirect tax structure is satisfactory from the point of view of the criterion of income elasticity. In order to conform to the criterion of economic stabilisation, indirect taxes should be levied on goods with a high income elasticity of demand. The significance of this criterion lies in the fact that such indirect taxes would be ideally suited for maximum volume of resource mobilisation.

From Table 4, we can see the rate of change of indirect taxes as percentage of total current revenue and Gross Domestic Product during 1960-78. For all of the countries the rate of change was uneven and inconsistent. However, a better gauge of the relevant significance of indirect taxes in the Caribbean can be obtained from examining indirect tax revenues as a ratio of total tax revenue as exhibited in Table 3. In Barbados, after 1973, indirect taxes declined to less than 50 percent. A similar situation prevailed in Trinidad and Tobago and Guyana after 1972 and 1976 respectively, while in Jamaica indirect taxes have never been less than 50 percent during 1960-78 indicating the growing and significant importance attached to indirect taxes as a source of development finance in Jamaica. Moreover, it has been claimed that Jamaican indirect taxes are essentially proportional to both income or expenditure, except in the highest in-

**TABLE 3**

**Percentage of total tax revenue from indirect taxes, 1960-78**

| *Year* | *Barbados* | *Guyana* | *Jamaica* | *Trinidad and Tobago* |
|---|---|---|---|---|
| 1960 | 70.9 | 62.0 | 65.3 | 48.8 |
| 1965 | 62.1 | 65.5 | 65.8 | 53.1 |
| 1970 | 54.8 | 55.9 | 54.9 | 47.5 |
| 1971 | 49.2 | 59.1 | 52.9 | 49.1 |
| 1972 | 50.5 | 50.0 | 51.9 | 50.1 |
| 1973 | 60.6 | 52.9 | 50.9 | 46.9 |
| 1974 | 47.5 | 69.9 | 62.5 | 26.9 |
| 1975 | 42.3 | 75.8 | 65.1 | 24.2 |
| 1976 | 48.2 | 64.3 | 61.6 | 25.9 |
| 1977 | 44.8 | 45.8 | 64.0 | 26.0 |
| 1978 | 46.2 | 48.7 | 71.5 | 24.5 |

*Sources:* Same as for Table 1; Table 2.

1. S. Cnossen, *Excise Systems: A Global Study of the Selective Taxation of Goods and Services* (Baltimore: Johns Hopkins University Press, 1977), p. 7.

come bracket.[2] In Guyana, indirect taxes were found to have an income elasticity coefficient of 2.1, in Jamaica the income elasticity was 1.9, and in both Barbados and Trinidad and Tobago the income elasticity was 0.9.[3] The average income elasticity of indirect taxes for the four countries as a whole is 1.5.

**TABLE 4**

**Indirect tax revenues as a ratio of total current revenue and GDP, 1960-78**

(Percentages)

| Year | Barbados | | Guyana | |
|---|---|---|---|---|
| | *As a ratio of current revenue* | *As a ratio of GDP* | *As a ratio of current revenue* | *As a ratio of GDP* |
| 1960 | 69.9 | 4.5 | 57.1 | 6.8 |
| 1965 | 56.5 | 11.2 | 59.9 | 11.4 |
| 1970 | 44.5 | 8.7 | 48.2 | 12.5 |
| 1971 | 41.5 | 11.2 | 50.1 | 11.8 |
| 1972 | 42.9 | 11.3 | 43.0 | 11.5 |
| 1973 | 65.7 | 13.7 | 32.3 | 8.4 |
| 1974 | 40.9 | 8.0 | 63.4 | 20.5 |
| 1975 | 36.3 | 7.8 | 71.2 | 29.9 |
| 1976 | 42.9 | 11.2 | 55.2 | 19.1 |
| 1977 | 40.3 | 10.0 | 38.8 | 12.1 |
| 1978 | 40.9 | 9.9 | 38.2 | 12.3 |

| Year | Jamaica | | Trinidad and Tobago | |
|---|---|---|---|---|
| | *As a ratio of current revenue* | *As a ratio of GDP* | *As a ratio of current revenue* | *As a ratio of GDP* |
| 1960 | 49.9 | 3.9 | 38.8 | 3.8 |
| 1965 | 59.9 | 12.4 | 41.3 | 7.5 |
| 1970 | 49.8 | 5.1 | 40.5 | 12.6 |
| 1971 | 49.3 | 9.2 | 40.8 | 6.9 |
| 1972 | 45.2 | 9.1 | 42.8 | 7.4 |
| 1973 | 47.8 | 9.5 | 42.6 | 8.0 |
| 1974 | 59.4 | 14.5 | 24.3 | 7.7 |
| 1975 | 95.9 | 15.4 | 22.6 | 7.1 |
| 1976 | 58.5 | 14.0 | 23.3 | 7.6 |
| 1977 | 58.7 | 12.9 | 24.1 | 8.3 |
| 1978 | 68.3 | 19.0 | 23.0 | 7.5 |

*Sources:* Same as for Table 1; Table 1.

The coefficient of income elasticity of tax revenue indicates by how many percentage points a specific revenue source increases with an increase of one percentage point in income as well as it expresses the ratio between the marginal tax rate and the tax ratio of the earlier period. When the elasticity coefficient is greater than one, taxes are considered to be elastic and regarded as inelastic if the coefficient is less than one. In terms of the individual indirect taxes, the elasticity coefficients are shown in Table 5.

As one might expect, there is considerable variation in the value of the coefficient for the indirect taxes in the four countries. However, both Guyana and Jamaica have elastic indirect taxes while only the production and sales taxes indicate some degree of elasticity in Barbados and Trinidad and Tobago. All of the four countries have relied relatively more on their production and sales taxes than on the international trade taxes, in terms of tax effort, as suggested by the data. These data, therefore, lend some support to the general impression that with the growth and diversification of their economies the developing countries have been turning more effort toward the exploitation of internal taxes with diminishing relative reliance on international trade taxes.

**TABLE 5**

**Income elasticities of indirect tax revenues, 1970-76**

| *Country* | *Production and sales taxes* | *Trade taxes* | *Total indirect taxes* [a] |
|---|---|---|---|
| Barbados | 1.3 | 0.5 | 0.9 |
| Guyana | 2.8 | 1.8 | 2.1 |
| Jamaica | 4.8 | 4.2 | 1.9 |
| Trinidad and Tobago | 2.1 | −0.4 | 0.9 |

a 1960-76.

Indirect taxes in the Caribbean have been instrumental in bringing about an allocation of resources to some priority uses. Excise taxes have resulted in the reduction of the production of goods not regarded as essential for development; thus, resources have been channeled into the production of high priority goods under the assumption that demand is not perfectly inelastic. In the context of the growth of industrial production which in many cases means the production of domestic goods as substitutes for foreign imports, excise taxation not only makes up the loss in revenues caused by a fall in the proceeds from import taxes, but also becomes a very productive and expansive source of development finance.

One of the greatest weaknesses of indirect taxes in less developed countries, and the Caribbean is no exception, is their inability to reach high concerntrations of income and wealth as effectively as direct taxes. To that extent, indirect taxes can be regarded as regressive. Under the ability-to-pay principle taxes should bear some relationship to people's capacity to pay them. That is, the amount of taxes should be the same for people in the same economic position (horizontal equity), but different for people in different economic positions (vertical equity). Historically, however, indirect taxes, by their very nature, have never been able completely to satisfy these two criteria both in developed and developing countries.

2. Charles E. McLure, Jr., *The Incidence of Jamaican Taxes 1971-1972* (Kongston, Jamaica: Institute of Social and Economic Research, University of the West Indies, Working Paper No. 16, 1977), pp. 74-75.
3. Estimates of elasticities have been derived by fitting a long-linear function to the data for the period 1960-76 with gross domestic product as the independent variable.

## DIRECT TAXES

As for the direct taxes in the Caribbean, Table 6 indicates that they have been growing as a source of revenue. In all four countries total direct taxes have shown an uneven growth during the period 1970-78. In terms of the relative magnitude of the growth with respect to current revenues, increases in direct taxes as a percentage of current revenues were most pronounced in both Guyana and Trinidad and Tobago. In Guyana, direct taxes were up from an annual average of 32.7 percent of current revenues in 1972-76 to 40.3 percent in 1978, and in Trinidad and Tobago, from 59.7 percent to 70.8 percent.

**TABLE 6**

**Composition of direct tax revenues, 1970-78**
(Millions of U.S. Dollars)

| | *Barbados* | | | *Guyana* | | |
|---|---|---|---|---|---|---|
| *Year* | *Income taxes* | *Property taxes* | *Total* | *Income taxes* | *Property taxes* | *Total* |
| 1970 | 13.0 | 0.8 | 13.8 | 24.1 | 2.2 | 26.3 |
| 1971 | 20.1 | 2.8 | 22.9 | 23.2 | 1.6 | 24.8 |
| 1972 | 18.4 | 3.0 | 21.4 | 33.1 | 1.7 | 34.8 |
| 1973 | 28.5 | 5.0 | 33.5 | 37.3 | 2.2 | 29.5 |
| 1974 | 27.0 | 5.4 | 32.4 | 35.6 | 1.6 | 37.2 |
| 1975 | 35.0 | 4.2 | 39.2 | 43.4 | 1.2 | 44.6 |
| 1976 | 41.9 | 4.4 | 46.3 | 49.3 | 2.5 | 51.8 |
| 1977 | 43.8 | 5.4 | 49.2 | 63.6 | 2.3 | 65.9 |
| 1978 | 43.6 | 4.8 | 48.4 | 57.2 | 2.2 | 59.4 |

| | *Jamaica* | | | *Trinidad and Tobago* | | |
|---|---|---|---|---|---|---|
| *Year* | *Income taxes* | *Property taxes* | *Total* | *Income taxes* | *Property taxes* | *Total* |
| 1970 | 66.5 | 1.1 | 67.6 | 124.1 | 20.2 | 144.3 |
| 1971 | 168.4 | 2.8 | 171.2 | 74.4 | 2.8 | 77.2 |
| 1972 | 188.2 | 3.2 | 191.4 | 80.0 | 2.7 | 82.7 |
| 1973 | 247.9 | 17.8 | 265.7 | 108.8 | 15.9 | 124.7 |
| 1974 | 234.0 | 15.4 | 249.4 | 277.4 | 10.0 | 287.4 |
| 1975 | 210.3 | 24.8 | 235.1 | 315.3 | 9.1 | 324.4 |
| 1976 | 209.3 | 21.6 | 230.9 | 344.9 | 10.0 | 354.9 |
| 1977 | 163.7 | 21.3 | 185.0 | 397.9 | 11.3 | 409.2 |
| 1978 | 184.4 | 19.2 | 187.6 | 411.4 | 14.5 | 425.9 |

*Sources:* Same as for Table 1; Table 1.

Regarding the composition of direct taxes, Table 7 shows that income taxes (personal and corporate) constitute by far the most important form of direct tax revenue. However, only in Trinidad and Tobago did income taxes average more than 50 percent of current revenues while only Barbados had property taxes of more than 4 percent.

The personal income tax is a compulsory payment to government that is imposed by legislation. Income taxes really belong to a fairly advanced stage of economic development yet they are found in operation in a large number of developing nations, the reasons being quite simply that everyone is expected to contribute toward the expenditures that lead to development and this contribution is derived primarily from income.

**TABLE 7**

**Direct taxes as a ratio of current revenues, 1972-76 and 1978**
(Percentages)

| | *Income taxes* | | *Property taxes* | | *Total direct taxes* | |
|---|---|---|---|---|---|---|
| *Country* | *1972-76* | *1978* | *1972-76* | *1978* | *1972-76* | *1978* |
| Barbados | 39.8 | 43.0 | 5.7 | 4.7 | 45.5 | 47.7 |
| Guyana | 31.2 | 38.9 | 1.5 | 1.4 | 32.7 | 40.3 |
| Jamaica | 36.4 | 24.5 | 2.5 | 2.8 | 38.9 | 27.3 |
| Trinidad and Tobago | 55.8 | 68.4 | 3.9 | 2.4 | 59.7 | 70.8 |

*Sources:* Same as for Table 1; Table 6.

Taxation of net income in the Caribbean is complicated by many problems relating to permissible business expenses, including treatment of depreciation, exemptions and credits, and capital gains or casual profits. Hence, the measurement of net income for tax purposes is difficult and, as such, requires a high standard of administration for equitable results. However, personal income taxes in the Caribbean have been reasonably effective in reaching wage and salary income, where concealment is difficult.

As a percentage of total tax revenue, direct taxes in Barbados increased after 1973 to more than 50 percent. A similar situation prevailed in Trinidad and Tobago after 1972 and in Guyana after 1976. In Jamaica, direct taxes have always been less than 50 percent of total tax revevues during 1960-78.

**TABLE 8**

**Percentage of total tax revenue from direct taxes, 1960-78**

| *Year* | *Barbados* | *Guyana* | *Jamaica* | *Trinidad and Tobago* |
|---|---|---|---|---|
| 1960 | 29.1 | 38.0 | 34.7 | 51.2 |
| 1965 | 37.9 | 34.5 | 34.2 | 46.9 |
| 1970 | 45.2 | 44.1 | 45.1 | 52.5 |
| 1971 | 50.8 | 40.9 | 47.1 | 50.9 |
| 1972 | 49.5 | 50.0 | 48.1 | 49.9 |
| 1973 | 39.4 | 47.1 | 49.1 | 53.1 |
| 1974 | 52.5 | 30.1 | 37.5 | 73.1 |
| 1975 | 57.7 | 24.2 | 34.9 | 75.8 |
| 1976 | 51.8 | 35.7 | 38.4 | 74.1 |
| 1977 | 55.2 | 54.2 | 36.0 | 74.0 |
| 1978 | 53.8 | 51.3 | 28.5 | 75.5 |

*Sources:* Same as for Table 1; Table 1.

Direct taxes, or more specifically income taxation, are a very convenient device for introducing the principle of equity in tax structure. Due to the capacity of income taxation to introduce an element of built-in flexibility in the tax structure, it is regarded even in developed countries as a very important counter-cyclical device for achieving economic stabilisation. Thus, in the analysis of taxation in developing countries, the traditional objectives of progressivity and equity in taxation have pointed strongly to, and have resulted in, more aggressive use of net income and wealth taxation.

Though a highly progressive income tax with high marginal rates on upper income ranges is a very desirable fiscal instrument both on grounds of resource mobilisation for the public sector and redistributive considerations which are very important in less developed countries, it tends to conflict with the criteria of economic efficiency and progress in a context where the growth of savings and investment occupies an important place in the process of economic development, [4] as is the case in the Caribbean. Moreover, except in Trinidad and Tobago, income taxes are relatively elastic as seen in Table 9.

**TABLE 9**

**Income elasticities of direct tax revenues, 1970-76**

| *Country* | *Income taxes* | *Property taxes* | *Total direct taxes* |
|---|---|---|---|
| Barbados | 1.6 | 0.3 | 1.7 |
| Guyana | 1.2 | 0.6 | 1.1 |
| Jamaica | 2.3 | 22.3 | 2.6 |
| Trinidad and Tobago | 0.9 | −0.3 | 1.2 |

For the period 1970-76, there is considerable variation in the elasticity coefficients for direct taxes in the Caribbean. In both Barbados and Jamaica, property taxes have a higher than average income elasticity coefficient. Since 1973 Jamaica has been steadily increasing its property tax yield due to increasing property tax rates. However, overall, it may be said that all of the countries have relied relatively more on income taxes. In 1973, the Jamaican government proposed income tax relief for pensioners, payments of mortgage interest, health insurance and medical expenses, and premiums for equity-linked life insurance. But since the advantage of these reliefs are available only to Jamaicans paying income tax, and because the benefit of the reliefs rises with the taxpayer's marginal tax rate, these tax reductions reduce the burdens on upper income households, and therefore weaken the progressivity of the income tax and of the overall Jamaican tax system. [5]

Since 1974 the structure of the tax system has not undergone any major modification in Trinidad and Tobago. Largely because of the unique position of the country's petroleum sector and measures designed to tap the increased petroleum profits, income taxes now account for more than two thirds of total current revenues. In Barbados, the domestic revenue effort has been relatively stable since 1970, except for the strongly recessionary years of 1974-75. The country's income tax effort has shown some improvement due to increases in corporation tax rates and higher wages and salaries.

The increasing importance of the taxation of income and company profits in the Caribbean underline the need, therefore, for encouraging the growth of individual and business savings, and the ploughing back of retained profits of business into the expansion of investment. The tax policy should therefore be directed to further mobilisation of resources for development and allocating them according to development planning priorities.

## AN ASSESSMENT

Tax revenues represent the major proportion of all revenues collected in the Caribbean by the Central Government. Current tax revenues averaged about 86 percent of total current revenue in Barbados and Guyana, about 93 percent in Jamaica and about 90 percent in Trinidad and Tobago during 1970-78. Taxes, therefore, constitute an important part of the public finances of the Caribbean economy and as such a very important fiscal tool. The significance of tax revenue in the Caribbean can also be determined by examining the ratio of tax revenues to GDP. Tax revenues averaged 21.5 percent of GDP in Barbados, 26.3 percent in Guyana, 20.8 percent in Jamaica, and 23 percent in Trinidad and Tobago during 1970-78. The yield from taxation seems to indicate the response that migh be expected in a period of growing investment and national income as the countries attempt to move forward on their developmental paths. The tax ratios in the Caribbean are substantially higher than the average ratios in developing nations. The average ratio in developing nations, according to the most recent study, is 16.1 percent. [6]

As a fiscal tool, taxation has to aim at directing productive resources to uses which are necessary for development but which the private sector is unwilling to provide for, as is the case in the Caribbean. Such a direction of resources may be needed at certain times in developed countries also and may be engineered through a system of checks and incentives operating on decision-making units in the private sector. In the less developed nations, however, this may require, in addition, direct participation by government in production and investment activities. The major point being made here is quite simply that if fiscal policy is to make a net contribution to growth, its operations have to be supplemental to whatever can normally be expected to be achieved by the existing constellation of forces in the economy.

The object of both fiscal and development policy, therefore, is not to balance the budget of the public sector, but to balance the economy as a whole. In this respect, budgetary rules are different for governments than for individuals. It is important that governments should feel free to make appropriate use of budget surpluses or deficits, in conjunction with monetary and other policies, to counteract excesses or deficiencies of demand in the rest of the economy. [7]

4. Kempe R. Hope, *Development Policy in Guyana: Planning, Finance, and Administration* (Boulder: Westview Press, 1979), p. 164.
5. McCLure, *The Incidence of Jamaican Taxes 1971-1972*, p. 40.
6. See Alan Tait et al., "International Comparisons of Taxation for Selected Developing Countries, 1972-76", IMF *Staff Papers 26* (March 1979), pp. 129-130.
7. Walter Heller et al., *Fiscal Policy for a Balanced Economy* (Paris: OECD, 1968), p. 15.

**TABLE 10**

**Ratios of total tax revenues to total current revenue and GDP, 1960-78**

(Percentages)

| Year | Barbados Tax/GDP | Barbados Tax/Current revenue | Guyana Tax/GDP | Guyana Tax/Current revenue |
|---|---|---|---|---|
| 1960 | 6.4 | 98.5 | 10.9 | 92.1 |
| 1965 | 18.0 | 90.9 | 17.4 | 91.4 |
| 1970 | 21.9 | 81.4 | 22.4 | 87.6 |
| 1971 | 22.5 | 84.4 | 20.0 | 84.8 |
| 1972 | 22.0 | 85.1 | 23.3 | 87.5 |
| 1973 | 21.3 | 86.0 | 20.8 | 80.0 |
| 1974 | 20.1 | 86.2 | 29.3 | 90.8 |
| 1975 | 18.4 | 85.9 | 39.4 | 93.9 |
| 1976 | 23.3 | 89.1 | 29.6 | 85.8 |
| 1977 | 22.2 | 89.8 | 26.3 | 84.7 |
| 1978 | 21.5 | 88.7 | 25.3 | 78.5 |

| Year | Jamaica Tax/GDP | Jamaica Tax/Current revenue | Trinidad and Tobago Tax/GDP | Trinidad and Tobago Tax/Current revenue |
|---|---|---|---|---|
| 1960 | 5.9 | 76.3 | 7.8 | 79.4 |
| 1965 | 18.8 | 91.2 | 14.1 | 77.7 |
| 1970 | 17.4 | 90.7 | 14.8 | 85.4 |
| 1971 | 18.4 | 93.2 | 14.6 | 83.1 |
| 1972 | 18.3 | 87.0 | 15.3 | 85.4 |
| 1973 | 19.2 | 93.9 | 15.0 | 90.8 |
| 1974 | 20.8 | 95.0 | 26.0 | 90.3 |
| 1975 | 23.7 | 95.2 | 29.2 | 93.5 |
| 1976 | 22.7 | 94.9 | 29.5 | 90.1 |
| 1977 | 20.2 | 91.7 | 31.8 | 92.9 |
| 1978 | 26.6 | 95.6 | 30.6 | 93.8 |

*Sources:* Same as for Table 1; Tables 1, 2, 6; and United Nations, *Yearbooks of National Accounts Statistics* (Several Years).

In determining the size of the budget, tradition in the theory of public finance takes its cue from welfare economics: it is rewarding to transfer money from the private sector through taxation — and to give up individual decision power in the process — only to the extent that the public authority is presumed to spend the money better, i.e. to the extent that the public services provide better value than would have been derived from spending the money on individual goods and services. [8]

Though some advances in economic thought have conquered sufficient ground for these principles to have been accepted among most policy makers, one of the obstacles to their effective implementation has been the persistence of widespread public suspicion of unbalanced budgets. It is true that, as spending is generally popular and taxation is not, the temptation to political leaders to run budget deficits, not justified by the overall state of the economy, can be great. This can bring about all those consequences of excess demand and inflation, frequently combined with misallocation of resources, which prudent governments would seek to avoid. But no simple predetermined rules for the balancing of budgets can guarantee responsible government. Protection against irresponsible fiscal policy must rest on informed leadership coupled with the development of wide public understanding of the questions at issue. [9] Methods of ensuring that the leadership is adequately informed and public understanding sufficiently developed are, accordingly, subjects to be emphasised.

In light of the currently accepted social goal of an equitable distribution of the national product and on the basis of the above discussion of fiscal policy, the main objectives that should govern tax and budgetary policy in LDC's, such as those in the Caribbean, may be stated as follows: (1) a further increase in the rate of investment by further control over actual and potential consumption, (2) a further encouragement of the flow of investment into channels judged to be most desirable from the point of view of maximum benefit to society, and (3) a regulation of the flow of purchasing power in accordance with the overall pattern laid down in the development plans.

All of these objectives have been advocated and imposed by the International Monetary Fund on most of the Caribbean economies in recent years. These objectives are related to the ultimate goals of rapid increase in national income and of improvement in its distribution. The problem is to design and maintain a tax structure that will be conducive to the accomplishment of these objectives.

Given the level of revenue now derived from taxation, then the tax system in the Caribbean need only be directed increasingly toward meeting the long-term needs of development. This, therefore, implies a tax system with more administrative flexibility, one where incidence can be rationalised, and one which can be used as a means of controlling inflation — a major problem in the Caribbean. One of the major objectives of taxation in the Caribbean should be that of the mobilisation of internal resources to meet development financing requirements. The amount raised by a government is not necessarily linked to the amount it spends in providing services. Public funds come from other sources than taxation, but the power to tax is uniquely a power of government and its exercise is a matter of crucial importance to the economic and social life of a nation.

## CONCLUSIONS

It seems that the determining factors of tax structure for the Caribbean are primarily economic. The character of and change in the economic bases to be taxed are more important than the style of taxation. Taxation policies should be viewed in terms of their ability to support the government's needs for capital to finance economic development within the framework of the limits to the sources of the taxes. Excessive taxation may restrict economic incentives and productive efforts and may cause business activity and national income to decline. However, no definite answer can be given to the question of what is the optimum taxation level that could be carried by the Caribbean economies, or any economy for that matter. It seems, however, that given the elastic nature of the total direct taxes in all of the countries, they are prime candidates for increased tax rates. But, of course, these increased tax rates must be considered within the context of increased revenue, encouragement to non-inflationary impact, and administrative feasibility.

8. Dirk J. Wolfson, *Public Finance and Development Strategy* (Baltimore: Johns Hopkins University Press, 1979), p. 33.
9. Heller et al., *Fiscal Policy for a Balanced Economy*, p. 16.

# The effect of Income Taxes on Capital Budgeting in Nigeria

by A.C. EZEJELUE*

## I. INTRODUCTION

*Capital budgeting means long-term planning for proposed long-term capital investments and their financing. It is a many-sided activity that includes searching for new and more profitable investment proposals, investigating engineering and marketing considerations to predict the consequences of accepting the investment, and making economic analyses to determine the profit potential of each investment proposal.* [1] *Management is often faced with the problem of planning and controlling capital expenditure programmes for adding new facilities, replacement of existing equipment, introduction of new products, and embarking on extraordinary repairs. These are usually long-term propositions involving large outlays of money which may be financed out of working capital, or out of long-term borrowing, or out of share issues.*

*Therefore, before getting involved in such a capital expenditure programme it is desirable that management seek assurance that the expenditure will be worthwhile. Worthwhileness is more generally measured in terms of profitability. A number of factors will undoubtedly contribute to the profitability of such expenditure. "The capital budget, itemising the company's capital acquisitions, its appropriations, expenditures, tax shields and grants, will ultimately determine the company's profitability and in addition, its very ability to survive..."* [2]

*The purpose of this article is not to examine the modern techniques of capital budgeting, but rather to show the impact, if any, on a project's profitability of income taxes and related issues of capital allowances, and/or depreciation deductions and methods in the Nigerian environment. The fact has earlier been highlighted* [3] *that the implications of many investment decisions in Nigeria are so far-reaching that some projects considered otherwise as borderline cases may become worthwhile proposals, and therefore full consideration should always be given to the tax savings in every investment proposal.*

## II. INCOME TAX EFFECTS

Although a number of other forms of taxes may have some influence on the issue of capital budgeting, we shall limit our discussion here to the effects of company income tax.

Income taxes being cash disbursements are capable of playing an important role in capital budgeting by influencing the quantum and the timing of cash flows. But this depends on the possibility of reduction and/or reallocation of tax payments through non-cash expense deductions such as depreciation and capital allowances. Therefore corporate income taxes *per se*, as the impression is often created, do not always affect the incentive to invest in capital assets. Income taxes may or may not be a factor in evaluating capital expenditure. [4]

**CONTENTS**



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1. Harold Bierman and Seymour Smidt, *The Capital Budgeting Decision* (New York: MacMillan Co. Inc., 1975), p. 4.
2. Walter S. Goff, *Management Accounting for Managers* (London: MacDonald & Evans Ltd., 1975), p. 277.
3. See A.C. Ezejelue, "Nigeria: Tax Considerations for investment and business decisions", 33 *Bulletin for International Fiscal Documentation* (1979), pp. 398-408.
4. Gerald R. Crowningshield and Kenneth A. Gorman, *Cost Accounting* (New York: The MacMillan Co., 1972), p. 212.

Much will depend on the taxing law in operation in the particular environment. If the relevant *lex situs* on taxation makes it possible, through the treatment of depreciation and/or capital allowances, for the tax payment to be reduced or re-allocated so that, in the latter case, the payments could occur at more favourable times, then tax planning becomes an important factor in evaluating capital expenditure even though the total tax bill as measured in monetary units remains the same in the long run.

## III. EFFECTS OF DEPRECIATION AND DEPRECIATION METHODS

### A. Depreciation deductions

Where depreciation deductions which are non-cash expenses are allowable deductions for tax purposes, then they will afford tax shelters since they will protect an equal amount of earnings generated by the investment from taxation. In this kind of situation, therefore, it becomes financially expedient to introduce income tax effects into depreciation analysis. "[D]epreciation accounting in the absence of income taxes did not affect the investment decision, but the depreciation computed for tax purposes does affect the investment decision." [5] One effect of income tax depreciation accounting analysis is the possibility of improving the cash flow with the income tax saved as a result of treating the depreciation on the investment as a deductible expense for tax purposes.

Since the cost of the investment less its residual value represents a future tax deduction over the useful life of the asset, the present value of the deduction will depend on its specific yearly effects on future income tax payments. [6] In other words, the present value will be influenced not only by the tax rates and the discount rate but also by the depreciation method used.

### B. Depreciation method in use

If depreciable assets are the subject of the investment appraisal, the method of calculating depreciation will change the time pattern of the after-tax cash flows. A number of depreciation methods exist, including straight-line method, reducing balance method, sum-of-the-years's-digits method, and revaluation method. If companies have considerable leeway in the choice of depreciation method to write off their assets for tax purposes, any method that is advantageous from a cash position point of view should be adopted in making capital expenditure decisions. For example, in the United States, "Under the internal revenue code, a company has a choice (among other methods) of depreciating a new asset by using straight-line depreciation, sum-of-the-year's digits, or twice straight line on the declining balance... [I]t has frequently been noted that the choice of depreciation method will affect the profitability of the investment." [7]

From the illustration below, it is clear that any of the decreasing-charge methods, such as the sum-of-the-year's-digits or the reducing balance, will accelerate depreciation deductions in the earlier years and therefore maximize the present values of income tax savings. The beauty of the accelerated methods as applied to capital budgeting is that they provide a larger tax shelter by postponing tax outlays to future periods. In view of the time value of money, present tax savings are more advantageous than future tax savings. The motto in income tax planning is: "When there is a legal choice, take the deduction sooner rather than later; and recognise taxable income later rather than sooner." [8]

### Illustration I

Chinasa Ltd. has just bought block moulding equipment for ₦40,000. The equipment has a four-year life and no residual value. The minimum desired rate of return, after taxes, is 10 percent. Assuming that the relevant tax law recognises depreciation as a tax deductible expense, show the financial effects of using (i) an accelerated depreciation method, and (ii) a fixed instalment method, given that the tax rate for the period remains at 50 percent.

(i) *Sum-of-the-year's-digits depreciation*

Sum of digits = S = $\frac{n(n+1)}{2}$ (where n = years of estimated life) = $\frac{4(4+1)}{2}$ = 4 x 2.5 = 10

| *Year* | *Multiplier* | *Deduction* | *Income tax effect: tax savings at 50%* | *Present value at 10% factor* | *TOTAL PV* |
|---|---|---|---|---|---|
| | | ₦ | N ₦ | ₦ | ₦ |
| 1 | 4/10 | 16,000 | 8,000 | .909 | 7,272 |
| 2 | 3/10 | 12,000 | 6,000 | .826 | 4,956 |
| 3 | 2/10 | 8,000 | 4,000 | .751 | 3,004 |
| 4 | 1/10 | 4,000 | 2,000 | .683 | 1,366 |
| | | TOTAL PRESENT VALUE . . . | | | ₦16,598 |

(ii) *Straight-line depreciation*

Yearly depreciation = ₦40,000 : 4 = ₦10,000

Income tax effect: Savings at 50% = ₦5,000

Present value of ordinary annuity of ₦1.00 at 10% factor = 3.170

Present value of ordinary annuity of ₦5,000 at 10% factor = 3.170 x 5,000 = ₦15,850

The net difference in total present values in favour of using an accelerated method of depreciation is ₦(16,598 — 15,850) = ₦748. It follows therefore that where depreciation is an allowable expense for tax

5. Harold Bierman and Allan R. Drebin, *Managerial Accounting* (New York: The MacMillan Co., 1972), p. 212.
6. Charles T. Horngren, *Introduction to Management Accounting* (New Jersey: Prentice-Hall, Inc., 1978), p. 392.
7. Bierman and Smidt, op. cit., p. 132.
8. C.T. Horngren, op. cit., p. 393.

purposes, the depreciation method used has a major influence on the present value of the stream of tax savings. Although we have assumed a fixed tax rate, tax rates and discount rates also have material influences on the present value of the tax deductions.

### C. Tax treatment of depreciation in Nigeria

As we have shown earlier, depreciation computed for tax purposes affects investment decisions only if the relevant tax law treats depreciation as a deductible expense for tax purposes.

The present position in Nigeria is that the relevant tax laws [9] disallow depreciation of any asset, among other deductions, for tax purposes. In its place, the law grants capital allowances [10] on qualifying capital expenditure to companies and businesses. These capital allowances are principally made up of initial and annual allowances. Since in our illustration above we assumed a zero residual value at the end of the estimated useful life of the equipment there will be no balancing adjustment by way of either balancing allowance or balancing charge. However, in order to encourage investment in agriculture, all capital expenditures on plant and equipment incurred in agricultural production attract an investment allowance of 10 percent in addition to the existing capital allowances. [11]

## IV. EFFECT OF OUR TAXING POLICY ON INVESTMENT DECISIONS

The total effect of disallowing depreciation for tax purposes in Nigeria is to nullify the financial effect of any selected depreciation method on investment decisions. Therefore depreciation methods in use do not offer any inducement to investment in new capital assets. Rather, the inducements are offered through capital allowances and the investment allowance where applicable.

**CURRENT SCHEDULE OF NIGERIAN CAPITAL ALLOWANCES**

The current schedule of Nigerian capital allowances is to be found in the Companies Income Tax Decree 1979 (Decree No. 28) Schedule 2 as amended by Section 35 of the Finance (Miscellaneous Taxation Provisions) Decree 1979 (Decree No. 98):

| *Qualifying expenditure in respect of* | *Initial Allowances* | *Annual Allowances* |
|---|---|---|
| | Rate % | Rate % |
| Qualifying building expenditure | 5 | 10 |
| Qualifying industrial building expenditure | 15 | 10 |
| Qualifying mining expenditure | 20 | 12½ |
| Qualifying plant expenditure | 20 | 12½ |
| Qualifying plantation expenditure | 25 | 15 |

This is unlike in the United States, where the method of depreciation selected by a company has a significant effect on the tax computations. What is relevant for capital budgeting purposes in Nigeria, therefore, are the various capital allowances (investment allowances in some cases) and not depreciation because only the former shelter the company's profits from tax. Thus:

| | ₦ |
|---|---|
| Accounting profit before taxation | 30,000 |
| Add: Depreciation . . . . . . | 12,000 |
| Adjusted profit for tax purposes | 42,000 |
| *Deduct:* Capital allowances (tax shield) | 15,000 |
| Taxable income . . . . . . | ₦27,000 |

The position appears to be the same in Nigeria as in the United Kingdom. "Taxation would affect the negative cash flow caused by buying and using the machine by virtue of investment grants, writing down allowances and balancing allowances or balancing charges." [12] Therefore, for capital budgeting purposes it is the capital allowances which produce the tax shelter.

#### Illustration II

Chizoba Ltd. is considering buying breadmaking equipment for ₦20,000. The equipment which will earn ₦5,000 annually will be scrapped for ₦1,000 at the end of its sixth year. Assume that the initial allowance for this kind of asset is 40 percent while its annual allowance is 25 percent. The minimum desired rate of return is 10 percent. Assume also a fixed tax rate of 45 percent. Will the investment be advisable?

Since there is a negative net present value, the desired investment is not worthwhile. This view is also supported by the profitability index which is less than one. The investment could have been acceptable if the net present value $\geqslant 0$ or the profitability index $\geqslant 1$. So long as the net present value $\leqslant 0$, which suggests a rejection of the proposal, the profitability index may be superfluous. However, the profitability index tends to make the present value approach more appreciable to management and would be more meaningful for making a choice among conflicting proposals.

The above illustration shows how our capital allowance and not depreciation constitutes a tax shelter to a company. It does this by its offsetting effect against earnings, thereby legally reducing or avoiding tax liability. A going concern has no choice either in the rates of capital allowances or in the way or ordering capital allowances claims to any greater advantage.

9. See S. 22(c) of Companies Income Tax Decree (Decree No. 28) 1979; S. 18(g) of Income Tax Management Act, 1961.
10. See paragraphs 6, 7, 8, 10 of Schedule 2 to Companies Income Tax Decree 1979; paragraphs 7, 8, 10, 11 of Fifth Schedule to Income Tax Management Act, 1961.
11. A.C. Ezejelue, op. cit., p. 404.
12. R.E. Palmer and A.H. Taylor, *Financial Planning and Control* (London: Pan Books Ltd., 1972), p. 26C. (Some of these allowances are similar to our capital allowances.)

## CHIZOBA LTD

### Solution: Investment appraisal

(Tax considerations using present-value approach)

| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 |
|---|---|---|---|---|---|---|---|---|---|
| *YEAR* | *Written down value* | *Annual cash earnings* | *Initial allowance* | *Annual allowance* | *Taxable earnings* | *Tax at 45% on PYB** | *After-tax earnings* | *Discount at 10% factor* | *Total present value* |
| | *beginning of year* | | 40% | 25% | (2-3-4) | (45% of 5) | (2-6) | *PV Table* | (7 x 8) |
| | ₦ | ₦ | ₦ | ₦ | ₦ | ₦ | ₦ | ₦ | ₦ |
| 1 | 20,000 | 5,000 | 8,000 | 5,000 [13] | (8,000) | – | 5,000 | .909 | 4,545 |
| 2 | 7,000 | 5,000 | – | 1,750 | 3,250 | (3,600) | 8,600 | .826 | 7,104 |
| 3 | 5,250 | 5,000 | – | 1,313 | 3,687 | 1,463 | 3,537 | .751 | 2,656 |
| 4 | 3,937 | 5,000 | – | 984 | 4,016 | 1,659 | 3,341 | .683 | 2,282 |
| 5 | 2,953 | 5,000 | – | 738 | 4,262 | 1,807 | 3,193 | .621 | 1,983 |
| **6 | 2,215 | 5,000 | – | – | 3,785 | 1,918 | 1,867 | .564 | 1,053 |
| 7 | – | – | – | – | – | (1,703) | (1,703) | .513 | (874) |
| Total present value | | | | | | | | | 18,749 |
| Net present value ₦(20,000 – 18,749) | | | | | | | | | (1,251) |

Profitability/Desirability index: $\frac{\text{Present value of net cash benefits}}{\text{Present value of outlays}} = \frac{E}{C} = \frac{19623}{(20000 + 874)} = \frac{19623}{20874} = \underline{0.940}$

* The lag factor applied in tax payment is due to the application of the preceding year basis (PYB) of assessment.

** At the end of year six, a balancing adjustment is made. The loss on disposal of ₦1,215 = (2,215 – 1,000) at the end of year six is deducted from the earnings of year six and charged to tax in year seven. The loss constitutes a balancing allowance. There is nil annual allowance in the year of disposal. The adjustment, i.e. the merging of earnings and loss on disposal in year six, is necessary for the purposes of present-value computation.

Although the rates are subject to change, they are matter for the tax law which must be adhered to by all concerned.

It is occasionally obliquely implied [14] that even in a place such as Nigeria where depreciation is not tax deductible that the effect of the depreciation method selected could affect a capital budgeting decision if (as is often the case) the depreciation deductions used for prudent accounting purposes are greater than the capital allowances used for tax purposes.

This conception appears to be erroneous for the simple fact that once depreciation is non-tax deductible, it has no place in the capital budgeting analysis. Out tax law *simpliciter* does not admit it, and therefore we need not include it when discussing non-cash items that provide tax shelters in capital budgeting. Any depreciation deduction made as may be necessitated by prudent accounting is added back for tax purposes, thereby making it ineffectual in providing a tax shelter. Since governments use tax laws to influence the level of capital investments, capital expenditure decisions are expected to be consistent with the relevant tax laws of the particular environment.

However, where it becomes possible in future for our tax law to incorporate an option for companies to choose an annual rate considered suitable to them for calculating the annual allowances, then it becomes intelligible, as in the case of the depreciation method selected, for companies to talk of an accelerated or reduced rate as it affects their tax-sheltered items.

Where there is zero or inadequate earnings to take care of the capital allowances claims, they may be carried to a future year with higher earnings. For the purposes of present value, however, the tax shelter should be phased into the period in which tax becomes payable.

When the asset is scrapped, sold, or disposed of it attracts either a balancing allowance or a balancing charge. [15] Where the proceeds or a sale or disposal exceed the residual value of the assets (arrived at after deducting the cumulative capital allowances to the date of disposal) there will be a balancing charge. The reverse effect attracts a balancing allowance. For capital budgeting purposes, a balancing charge incurs a tax liability for a company while a balancing allowance provides a tax shield.

13. It is assumed that the basis period for the first year of assessment is a period of not less than one year — otherwise the annual allowance would be proportionally reduced. See provisos to paragraph 7 of Schedule 2 to Companies Income Tax Decree 1979 and to paragraph 8 of Fifth Schedule to Income Tax Management Act 1961.

14. See, for example, F.O. Okafor, *Analysis of Financial Statements*, Monograph, April 1980.

15. See paragraph 9 and 10 of Schedule 2 to Companies Income Tax Decree 1979 and paragraphs 10 and 11 of Fifth Schedule to Income Tax Management Act, 1961.

## V. POSSIBLE TAX ADVANTAGE THROUGH CAPITAL ALLOWANCE MANOEUVRABILITY

We have said earlier that a going concern cannot manoeuvre capital allowance claims to any special advantage. However, this kind of manoeuvrability is possible in the case of new Nigerian businesses.

Our tax laws [16] allow a new company the option to elect to be assessed for its second and third years of operation on the actual profits of those years instead of being assessed for those years on the special rules for new trades or businesses. The implication of this is that the exercise of this option by a company will accelerate the claiming of capital allowances in respect of any assets bought within the first three financial years. [17] Thus:

### Illustration III

Chidinma commenced business on January 1, 1974 and makes up its account to December 31 of each year. The following assets qualifying for initial allowance were bought:

| | |
|---|---|
| January 1, 1974 ... | ₦3,000 |
| May 1, 1974 ... | ₦4,000 |
| September 1, 1975 ... | ₦2,000 |
| February 27, 1976 ... | ₦1,500 |

The initial allowances will fall to be claimed as follows:

| *Date bought* | *Cost Naira* | *Where no option is exercised* | *Where option is is exercised* |
|---|---|---|---|
| Jan. 1, 1974 | 3,000 | 1973 - 74 | 1973 - 74 |
| May 1, 1974 | 4,000 | 1974 - 75 | 1974 - 75 |
| Sept. 1, 1975 | 2,000 | 1976 - 77 | 1975 - 76 |
| Feb. 27, 1976 | 1,500 | 1977 - 78 | 1975 - 76 |

(*Source:* A. C. Ezejelue, "Nigeria: Tax Considerations for Investment and Business Decisions", 33 *Bulletin for International Fiscal Documentation* (1979), p. 405.

From the capital budgeting point of view the accelerated claiming of capital allowances has the same effect as the accelerated depreciation deductions in the earlier years, that is to say, maximizing the present values of income tax savings because it provides a larger tax shield by postponing tax outlays to future periods.

## VI. SUMMARY

Capital budgeting usually involves a large investment outlay of funds in one time period with a promise to obtain a net funds inflow in a future time period. The impact of such huge outlay on the profitability and continued existence of any organization is so far reaching that it is not a matter to toy about with. Therefore all available merits of the investment must be analysed before embarking on the investment proposal.

Nowadays, the effects that taxation will have on cash flows is of much relevance in appraising the merits of any capital expenditure. In fact, the forces of taxation are too large to ignore, and the analyst must recognize them, giving particular attention to the options his firm faces that may permit lessening the adverse effects of the tax claim on the project he is studying. [18]

The present value of a project will depend on the quantum and the timing of the cash flows occasioned by the project. The Nigerian government attempts to stimulate capital investments through granting of capital and investment allowances rather than depreciation which is employed purely for prudent accounting purposes. Decreasing the total amount of taxes to be paid during the life of the asset has an inducement effect of increasing the present values of the benefits expected from the investment proposals. Alternatively, it decreases the present values of the expected expenditure proposals.

Since the Nigerian tax laws grant liberal capital and investment allowances to stimulate investments, managers should not only have a wide appreciation of their possible tax effects on capital budgets but will seek expert advice and analysis where necessary. This is particularly urged because no capital allowance shall be granted to any company unless claimed by it or where the tax board is of the opinion that it would be reasonable and just to grant it. [19] The possibility of the latter appears to be remote.

16. See S. 24 (3)(d) of Companies Income Tax Decree 1979; Sec. 20 (3)(d) of Income Tax Management Act 1961.
17. A.C. Ezejelue, op. cit. p. 405.
18. Pearson Hunt et al. *Basic Business Finance* (Illinois: Irwin Inc., 1975), p. 155.
19. Paragraph 22 of Schedule 2 to Companies Income Tax Decree 1979; paragraph 27 Fifth Schedule to Income Tax Management Act 1961.

# Nigeria: BUDGET 1980

**Extract of a statement made by the Federal Minister of Finance, Professor S.M. Essang, on March 31, 1980.**

. . . .

2. As you are aware, this is the first budget, which the new Civilian Administration has prepared since it came into office on the 1st of October, 1979. Moreover, an important feature of this Budget is that this fiscal year will run for only 9 months as against the normal 12 months because of the change over to calendar year which runs from January to December.

3. As an elected Government which was voted to office to carry out the promises it made to the electorate, our proposals differ in emphasis from those in the previous years. Accordingly, various measures I will announce to you now are designed to achieve the present Administration's policy objectives which consist of:

(i) rationalisation of existing fiscal measures with a view to removing unwarranted impediments in the areas of production and trade;
(ii) diversification of the Government revenue base;
(iii) facilitating the dispersal of industries;
(iv) encouraging the manufacturing sector to increase the use of local raw materials and thereby local value added;
(v) facilitating vigorous and relentless implementation of government's priority programmes in the areas of agriculture, housing, industrialization, etc.;
(vi) increasing the availability of essential food items to the generality of our people;
(vii) reduction of the level of unemployment by increasing the tempo of economic activities;
(viii) reduction of the rate of inflation by increasing local production through a combination of the foregoing measures and supplementing local production with imports of essential items as well as by appropriate combination of fiscal and monetary measures;
(ix) ensuring a more equitable distribution of output and incomes in the economy.

## FISCAL MEASURES

4. The Federal Government has made a critical review of the various fiscal measures adopted by the previous Administration since 1975 with a view to determining a new direction of policy and in order to achieve the objectives stated above. As you are aware, the policy of imports liberalisation which characterised the 1975/76 and 1976/77 budgets had to be reversed in the subsequent budgets in order to avoid disaster. There was a swing of the pendulum to the other extreme of severe import restrictions which imposed considerable hardship on both consumers and entrepreneurs in the economy. For example, even though the rationale behind import restriction was to maintain a healthy external reserve and protect local industries, yet the severity of those restrictions led to higher domestic prices, higher rate of smuggling and under-utilisation of port facilities. It is against this background that the present Administration has decided to adopt a combination of policies that will produce a self-reliant economy and at the same time bring about a healthy balance of payments position. However, we are aware that frequent changes in fiscal policy tend to generate an atmosphere of uncertainty, which militates against investment decisions. Therefore, I wish to caution that the mere fact that we are currently experiencing rising crude oil prices should not be taken as a signal for pursuing the kind of import liberalisation policy of 1975 to 1977.

### Agriculture

5. In addition to the existing incentives granted in previous years, and because of the importance attached to agriculture by this Administration, import duty on fishing vessels is abolished in order to bring the concession in line with free import duty on agricultural machinery and equipments.

### Manufacturing Industry

6. The industrial policy of this Administration is to promote geographical spread of industries in order to achieve even industrial development throughout the whole country. To this end, concessions on a sliding scale in the form of approved user scheme will be granted to industries located in the hinterland which import their raw materials. The farther inland and away from the port the smaller the duty payable and vice versa. To encourage the use of local raw materials the higher the local value added the less excise duty shall be payable.

(i) *Commercial vehicle assembly/manufacturing plants*

To protect the local assembler/manufacturer of commercial vehicles the duty or CBU (completely built up) vehicles is raised from 20 percent to 35 percent. To take account of differences in location, the following differential rates of duty are introduced on CKD parts imported by local commercial vehicle assemblers/manufactureres:
(a) approved assemblers/manufacturers in Lagos 20 percent;
(b) approved assemblers/manufacturers in Ibadan 18 percent;
(c) approved assemblers/manufacturers in Enugu 15 percent;
(d) approved assemblers/manufacturers in Kano 10 percent;
(e) approved assemblers/manufacturers in Bauchi 5 percent.

(ii) *Electric fans*

To protect local assemblers/manufacturers of ceiling fans;
(a) import duty is raised from 50 percent to 75 percent;
(b) duty on motors is reduced from 33 1/3 percent to 10 percent.

(iii) *Galvanized flat sheet*

The duty on flat galvanized iron sheet is raised from 20 percent to 25 percent to protect local industry. Because of excess local capacity, an import licence shall not be granted without a letter of release.

(iv) *Lamp shades*

To protect local industry, import duty on lamp shades is raised from 40 percent to 50 percent.

(v) Duty has also been revised upwards for such items as tarpaulin, paper napkins, musical instruments, brass bed ornaments, wheel barrows to protect local industries and to raise revenue.

(vi) To correct some anomalies in the existing rates of duty whereby raw materials imported for further processing attract the same duty with the finished products, changes have been introduced on some raw materials such as bentonite and barite, artificial resins, raw materials for dumpers, brake lining and disc pad.

(vii) *Cement*

Duty has been removed on paper bags and selected spare parts of the machinery used by cement factories.

### Excise duty

7(i) Excise duty has been reduced on the following items:
- (a) margarine 10 to 5 percent
- (b) toothpaste 25 to 15 percent
- (c) perfumery products 25 to 15 percent

(ii) Excise duty has been imposed on umbrellas and metal crown corks at the rates of 25 kobo each and 5 percent respectively.

### Import prohibition

8(i) In order to encourage and protect local industries, the following items have been added to the import prohibition list:
- (a) bicycle tyres and tubes in sizes 28 x $1^1/2$; 26 x $1^3/8$; 26 x $1^3/8$ and 26 x $1^1/2$ x $1^1/8$;
- (b) concentrated malt extract;
- (c) jute bags;
- (d) fabrics for furniture.

(ii) To facilitate early resettlement and as a gesture to Nigerians returning home after a prolonged stay abroad to bring with them their personal effects, cars of engine capacity of 2,500cc and above brought by Nigerians who have stayed abroad for a period of not less than 9 months and for which foreign exchange transfer is not involved are removed from the import prohibition list. Such cars, will, however, attract 500 percent import duty.

### Import licence

9. To encourage sporting activities and for safety consideration of industrial workers the following items have been removed from prohibition list and placed under import licence:
- (a) sporting equipment not manufactured locally — football boots, spike shoes, boxing boots, cycling shoes, hockey boots, basketball boots, golf shoes, football jerseys and track suits;
- (b) Industrial protective footwear, disciplined forces footwear, gloves and apparel are to be imported under approved user licence.

### Open general licence

10. In addition to the items already on open general licence the following items have also been placed on open general licence:
- (a) stockfish;
- (b) louvre frames;
- (c) insulated electric wire;
- (d) plastic pipes;
- (e) linoleum of all types in rolls;
- (f) ceramic products such as sinks, wash hand basins, water closets, urinals and bidets.

The removal of these building materials from import restriction is to facilitate the implementation of the Federal and state governments' housing programme as well as to encourage the construction of individual owner-occupied houses.

## TAXATION

11. **Changes in the accounting year of government and its consequential effect on assessment years and basis periods**

The accounting year of government is now from 1st January to 31 December and consequently the annual assessment year for tax purposes shall also be from 1st January to 31st December. In respect of the year of assessment which under the existing procedure will be 1980/81, the assessment year will now be "1980 Assessment Year" and shall be for the period 1st April, 1980 to 31st December, 1980. All assessments and payment of tax shall be completed between nine months instead of the usual twelve months. As from 1981, the normal 12 months assessment year shall commence on 1st January, 1981.

12. **Basis period for assessment**

(a) The existing procedure of assessing on income of the previous year remains unchanged.

(b) Basis period for assessment year 1980 in respect of income of individuals (other than employment income) therefore remains 1/4/79 — 31/3/80, while employment income will continue to be treated on current year basis. However, for the assessment year 1981, the basis period for individuals (other than employment income) shall be for the nine months ended 31/12/80.

(c) In respect of companies to which the Companies Income Tax Decree 1979 is applicable, the following distinctions have been made:
- (i) those who make up accounts for accounting years ending between 1st April to 31st December:
- (ii) those who make up accounts for accounting years ending between 1st January and 31st March;
- (iii) petroleum producing companies;

In respect of companies of business in category (i), the normal preceding year basis will apply without change in 1980, 1981 and future years. For those in category (ii) it has been decided that for the assessment year 1980, the basis period will be the period beginning from the commencement of their accounting year up to 31st December, 1979. For example, if a company makes up its annual accounts up to 28th February, the basis period for 1980 year of assessment will be 1st March, 1979 — 31st December, 1979. This means the basis period will be less than 12 months. For the assessment year 1981, the basis period will be from 1st January, 1980 up to the end of the accounting year. In the case of the company in the above example, the basis period for the year 1981 will be 1/1/80 — 28/2/80.

13. The normal procedures in commencement and cessation cases will continue to apply, provided where taxpayers' options are exercised in accordance with the Companies Income Tax Decree 1979 for assessment on actual basis in the 1980 assessment year, the profits of the full 12 months are to be computed where necessary on prorata basis.

14. Provisions as to payment of tax on receipt of notice of assessment remain unchanged, except payments of tax have to be completed between 1st January and 31st December instead of 1st April and 31st March of the following year. In this connection, "21st day of March" as contained in S.58 of the Company Income Tax Decree will now read 14th December.

15. In the case of Personal Income Tax, existing dates will be related and converted appropriately to equivalent dates in the new assessment year, e.g. 1st December in the old system will become 1st September in the new assessment year and 1st April becomes 1st December and 31st March becomes 31st December, etc. Taxpayers are expected to clear with relevant tax authorities, if in doubt. Petroleum producing companies will continue to pay tax on current year basis as usual from 1/1/80 — 31/12/80 without change.

16. The present system of regarding a Company and its shareholders as two distinct persons for income tax purposes will continue. Companies will therefore continue to pay Companies Income Tax at the rate of 45 percent while shareholders will in addition pay tax on the dividends or similar distributions from companies.

17. However, where dividends are paid by one Nigerian company to another, in order

to ensure that such dividends or such other distributions are not subjected to double taxation, the following procedure will be introduced this year:

(a) A company which is resident in Nigeria will be required to account to the Federal Board of Inland Revenue for income tax on the profits of the company and for income tax in respect of dividends paid or credited and other similar distributions made by it.

(b) A company, on paying or crediting a dividend or making any other payment which is a distribution in respect of which it is required to account for income tax, is authorised to deduct out of the distribution an amount equal to the income tax for which it is liable to account. In the case of dividends paid or credited by one company to another, the tax to be accounted for shall be at the rate of 45 percent and in the case of individuals the amount of tax to be accounted for shall be at the rate of 12½ percent.

(c) Dividends and other such distributions received by a company resident in Nigeria from another resident company on which the paying company is liable to account for income tax should be described as "franked investment income" of the recipient company. The recipient company is not charged to further income tax on such "franked investment income" but unless otherwise specifically exempted from tax, it is not entitled to repayment of the income tax accounted for by the paying company.

(d) In the case of a company or a non-resident individual, the tax deducted shall be accounted for to the Federal Board of Inland Revenue, and in all other cases to the relevant tax authority in which the individual is resident.

(e) In accounting for tax so deducted to a tax authority, the company shall state in writing the following particulars, that is to say:
   (i) the gross amount of the dividend or such similar distributions to each shareholder;
   (ii) the name and address of such recipient;
   (iii) the period of the accounting year in respect of which the dividend or distribution is paid;
   (iv) the amount of tax deducted and accounted for.

18. **Distribution of profits after tax**

Companies may distribute as dividends either a maximum of 60 percent of profits after tax or 25 percent of the paid-up capital, whichever is higher, provided such distributions are made out of current year profits.

19. **Tax deduction at source on rents paid by companies**

For the avoidance of doubt, the existing practice which was approved by government last year is as follows:

(i) Where any rent becomes due or payable by one company to another company or from one company to an individual, the Company paying such rent shall at the date when the rent is paid or credited, whichever first occurs, account to the Federal Board of Inland Revenue, or to a relevant State Tax Authority, income tax at the rate of 12½ kobo for each Naira.

(ii) A company, on paying any rent in respect of which it is required to account for income tax, shall deduct out of the rent paid or credited an amount equal to the income tax for which it is liable to account.

(iii) In accounting for the tax so deducted to the Federal Board or to any State Tax Authority, the company shall state in writing the following particulars, that is to say:
   (a) the gross amount of rent paid, credited per annum;
   (b) the name and address of the company to whom the rent has been paid or credited and the period in respect of which such rent has been paid or credited; and
   (c) the address or accurate description of the location of the property on which the rent is being paid.

20. In respect of payments of rent from one company to another, or from one company to a non-resident individual, the tax so deducted shall be remitted to the Federal Board of Inland Revenue. In all other cases, tax deducted shall be remitted to the relevant tax authority of the State in which the beneficiary of the rent is resident.

# COPYRIGHT ROYALTIES:

## *Conventions for the avoidance of double taxation*

The International Conference of States convened jointly by the UNESCO and the World Intellectual Property Organization (WIPO) in Madrid in November-December 1979 adopted the final text of a Multilateral Convention for the Avoidance of Double Taxation of Copyright Royalties, to which was annexed an optional Model Bilateral Agreement on the same subject. In 33 *Bulletin for international fiscal documentation* 382 (1979) Prof. J. van Hoorn Jr. made some critical observations with respect to the draft model multilateral treaty. In this issue the final text — which deviates from the draft — is reproduced together with the proposed draft bilateral treaty.

### MULTILATERAL CONVENTION FOR THE AVOIDANCE OF DOUBLE TAXATION OF COPYRIGHT ROYALTIES

The Contracting States,

*Considering* that the double taxation of copyright royalties is prejudicial to the interests of authors and thus constitutes a serious impediment to the dissemination of copyrighted works, which is one of the basic factors in the development of the culture, science and education of all peoples,

*Believing* that the encouraging results already achieved by action against double taxation, through bilateral agreements and domestic measures, whose beneficial effects are generally recognized, can be improved by the conclusion of a multilateral convention specific to copyright royalties,

*Being of the opinion* that these problems must be solved while respecting the legitimate interests of States and particularly the needs specific to those where the widest possible access to works of the human mind is an essential condition to their continuing development in the fields of culture, science and education,

*Seeking* to find effective measures designed to avoid double taxation of copyright royalties where possible and, should it subsist, to eliminate it or to reduce its effect,

Have agreed on the following provisions:

#### CHAPTER I
#### DEFINITIONS
#### Article 1
*Copyright royalties*

1. For the purposes of this Convention and subject to the provisions of paragraphs 2 and 3 of this Article, copyright royalties are payments of any kind made on the basic of the domestic copyright laws of the Contracting State in which these royalties are originally due, for the use of, or the right to use, a copyright in a literary, artistic or scientific work, as defined in the multilateral copyright conventions, including such payments made in respect of legal or compulsory licences or in respect of the "droit de suite".

2. This Convention shall not, however, be taken to cover royalties due in respect of the exploitation of cinematographic works or works produced by a process analogous to cinematography as defined in the domestic copyright laws of the Contracting State in which these royalties are originally due when the said royalties are due to the producers of such works or their heirs or successors-in-title.

3. With the exception of payments made in respect of the "droit de suite" the following shall not be considered as copyright royalties for the purposes of this Convention: payments for the purchase, rental, loan or any other transfers of a right in the material base of a literary, artistic or scientific work, even if the amount of this payment is fixed in the light of, the copyright royalties due or if the latter are determined, in whole or in part, by that of the said payment. When a right in the material base of work is transferred as an accessory to the transfer of the entitlement to use a copyright in the work, only the payments in return for this entitlement are copyright royalties for the purpose of this Convention.

4. In the case of payments made in respect of the "droit de suite" and in all cases of the transfer of a right in the material base of a work referred to in paragraph 3 of this Article and independently of the fact that the transfer in question is or is not free of charge, any payment made in settlement of or as a reimbursement for an insurance premium, transport of warehousing costs, agent's commission or any other remuneration for a service, and any other expenses incurred, directly or indirectly, by the removal of the material base in question, including customs duties and other related taxes and special levies, shall not be a copyright royalty for the purposes of this Convention.

#### Article 2
*Beneficiary of copyright royalties*

For the purposes of this Convention, the "beneficiary" of copyright royalties is the beneficial owner thereof to whom all or a part of such royalties is paid, whether he collects them as author, or heir or successor-in-title of the author, or whether he collects them in application of any other relevant criterion as agreed to in a bilateral agreement concerning double taxation of copyright royalties.

#### Article 3
*State of residence of the beneficiary*

1. For the purposes of this Convention, the State of which the beneficiary of the copyright royalties is a resident shall be deemed to be the State of residence of the beneficiary.

2. A person shall be deemed to be a resident of a State if he is liable to tax therein by reason of his domicile, residence, place of effective management or any other relevant criterion as agreed to in a bilateral agreement concerning double taxation of copyright royalties. But this term does not include any person who is liable to tax in that State in respect only of income from sources in that State as capital he possesses there.

#### Article 4
*State of source of royalty*

For the purposes of this Convention, a State shall be deemed to be the State of source of copyright royalties when such royalties for the use of, or the right to use, a copyright in a literary, artistic or scientific work are originally due:

a) by that State or by a political or administrative subdivision or local authority of that State;
b) by a resident of that State except where they result from an activity carried on by him in another State through a permanent establishment or from a fixed base;
c) by a non-resident of that State, where they result from an activity carried on by him through a permanent establishment or from a fixed base.

## CHAPTER II
## GUIDING PRINCIPLES FOR ACTION AGAINST DOUBLE TAXATION OF COPYRIGHT ROYALTIES

### Article 5
*Fiscal sovereignty and equality of rights of states*

Action against double taxation of copyright royalties shall be carried out, in accordance with the provisions of Article 8 of this Convention, with due respect for the fiscal sovereignty of the State of source and the State of residence, and due respect for the equality of their right to tax these royalties.

### Article 6
*Fiscal non-discrimination*

The measures against double taxation of copyright royalties shall not give rise to any tax discrimination based on nationality, race, sex, language or religion.

### Article 7
*Exchange of information*

In so far as it is necessary for the implementation of this Convention, the competent authorities of the Contracting States will exchange reciprocally information in the form and under the conditions which shall be laid down by means of bilateral agreement.

## CHAPTER III
## IMPLEMENTATION OF THE GUIDING PRINCIPLES FOR THE ACTION AGAINST DOUBLE TAXATION OF COPYRIGHT ROYALTIES

### Article 8
*Means of implementation*

1. Each Contracting State undertakes to make every possible effort, in accordance with its Constitution and the guiding principles set out above, to avoid double taxation of copyright royalties, where possible, and, should it subsist, to eliminate it or to reduce its effect. This action shall be carried out by means of bilateral agreements or by way of domestic measures.

2. The bilateral agreements referred to in paragraph 1 of this Article include those which deal with double taxation in general or those which are limited to double taxation of copyright royalties. An optional model of a bilateral agreement of the latter category, comprising several alternatives, is attached to this Convention of which it does not form an integral part. The Contracting States, while respecting the provisions of this Convention, may conclude bilateral agreements based on the norms that are most acceptable to them in each particular case. The application of bilateral agreements concluded earlier by the Contracting States is in no way affected by this Convention.

3. In case of adoption of domestic measures, each Contracting State may, notwithstanding the provisions of Article 1 of this Convention, define copyright royalties by reference to its own copyright legislation.

## CHAPTER IV
## GENERAL PROVISIONS

### Article 9
*Members of diplomatic or consular missions*

The provisions of this Convention do not affect the fiscal privileges of members of diplomatic or consular missions of the Contracting States, as well as of their families, either under the general rules of international law or under the provisions of special conventions.

### Article 10
*Information*

1. The Secretariat of the United Nations Educational, Scientific and Cultural Organization and the International Bureau of the World Intellectual Property Organization shall assemble and publish relevant normative information concerning taxation of copyright royalties.

2. Each Contracting State shall communicate, as soon as possible, to the Secretariat of the United Nations Educational, Scientific and Cultural Organization and to the International Bureau of the World Intellectual Property Organization, the text of any new law, as well as all official texts concerning the taxation of copyright royalties, including the text of any specific bilateral agreement on the relevant provisions on the said subject contained in any bilateral agreement dealing with double taxation in general.

3. The Secretariat of the United Nations Educational, Scientific and Cultural Organization and the International Bureau of the World Intellectual Property Organization shall furnish to any Contracting State, upon its request, information on questions, relating to this Convention; they shall also carry out studies and provide services in order to facilitate the application of this Convention.

## CHAPTER V
## FINAL CLAUSES

### Article 11
*Ratification, acceptance, accession*

1. This Convention shall be deposited with the Secretary General of the United Nations Organization. It shall remain open until October 31, 1980, for signature by any State that is a member of the United Nations, any of the Specialized Agencies brought into relationship with the United Nations or the International Atomic Energy Agency, or is a party to the Statute of the International Court of Justice.

2. This Convention shall be subject to ratification or acceptance by the signatory States. It shall be open for accession by any State referred to in paragraph 1 of this Article.

3. Instruments of ratification, acceptance or accession shall be deposited with the Secretary-General of the United Nations.

4. It is understood that, at the time a State becomes bound by this Convention, it will be in a position in accordance with its domestic law to give effect to the provisions of this Convention.

### Article 12
*Reservations*

The Contracting States may, either at the time of signature of this Convention or at the time of ratification, acceptance or accession, make reservations as regards the conditions of application of the provisions contained in Articles 1 to 4, 9 and 17. No other reservation to the Convention shall be permitted.

### Article 13
*Entry into force*

1. This Convention shall enter into force three months after the deposit of the tenth instrument of ratification, acceptance or accession.

2. For each State ratifying, accepting, or acceding to this Convention after the deposit of the tenth instrument of ratification, acceptance or accession, this Convention shall enter into force three months after the deposit of its instrument.

### Article 14
*Denunciation*

1. Any Contracting State may denounce this Convention by a written notification addressed to the Secretary General of the United Nations.

2. Such denunciation shall take effect twelve months after the date of receipt of

the notification by the Secretary General of the United Nations.

### Article 15
*Revision*

1. After this Convention has been in force for five years, any Contracting State may, by notification, addressed to the Secretary-General of the United Nations, request that a conference be convened for the purpose of revising the Convention. The Secretary-General shall notify all Contracting States of this request. If, within a period of six months following the date of notification by the Secretary-General of the United Nations, not less than one-third of the Contracting States, provided the number is not less than five, notify him of their concurrence with the request, the Secretary-General shall inform the Director-General of the United Nations Educational, Scientific and Cultural Organization and the Director General of the World Intellectual Property Organization, who shall convene a revision conference with a view to introducing into this Convention amendments designed to improve action against double taxation of copyright royalties.

2. The adoption of any revision of this Convention shall require an affirmative vote by two-thirds of the States attending the revision conference, provided that this majority includes two-thirds of the States which, at the time of the revision conference, are parties to the Convention.

3. Any State which becomes a party to the Convention after the entry into force of a new Convention wholly or partially revising this Convention shall, failing an expression of a different intention by that State, be considered as:

a) a party to the revised convention;
b) a party to this Convention in relation to any State which is a party to the present Convention but is not bound by the revised convention.

4. This Convention shall remain in force as regards relations between or with the Contracting States which have not become parties to the revised convention.

### Article 16
*Languages of the convention and notifications*

1. This Convention shall be signed in a single copy in Arabic, English, French, Russian and Spanish, the five texts being equally authoritative.

2. Official texts shall be established by the Director-General of the United Nations Educational, Scientific and Cultural Organization and the Director General of the World Intellectual Property Organization, after consultation with the interested Governments concerned, in the German, Italian and Portuguese languages.

3. The Secretary-General of the United Nations shall notify the States referred to in Article 11, paragraph 1, as well as the Director-General of the United Nations Educational, Scientific and Cultural Organization and the Director General of the World Intellectual Property Organization of

a) signature of this Convention, together with any accompanying text;
b) the deposit of instruments of ratification, acceptance or accession, together with any accompanying text;
c) the date of entry into force of this Convention under Article 13, paragraph 1;
d) the receipt of notifications of denunciation;
e) the requests communicated to him in accordance with Article 15, as well as any communication received from the Contracting State concerning the revision of this Convention.

4. The Secretary-General of the United Nations shall transmit two certified copies of this Convention to all States referred to in Article 11, paragraph 1.

### Article 17
*Interpretation and settlement of disputes*

1. A dispute between two or more Contracting States concerning the interpretation or in the matter of application of this Convention, not settled by negotiation, shall, unless the States concerned agree on some other method of settlement, be brought before the International Court of Justice for determination by it.

2. Any State may, at the time of signing this Convention or depositing its instrument of ratification, acceptance or accession, declare that it does not consider itself bound by the provisions of paragraph 1. In the event of a dispute between that State and any other Contracting State, the provisions of paragraph 1 shall not apply.

3. Any State that has made a declaration in accordance with paragraph 2 may at any time withdraw it by notification addressed to the Secretary-General of the United Nations.

IN WITNESS WHEREOF, the undersigned, being duly authorized, have signed this Convention.

DONE at Madrid on December 13, 1979.

# Model bilateral agreement for the avoidance of double taxation of copyright royalties

## PREAMBLE OF AGREEMENT

The Government of (State A) and the Government of (State B),

Wishing to apply the principles set out in the Multilateral Convention for the Avoidance of Double Taxation of Copyright Royalties and thus to eliminate such double taxation or to reduce its effect,

Have agreed on the following provisions:

## I
## SCOPE OF THE AGREEMENT

### Article I
*Persons and royalties covered*

1. This Agreement shall apply to persons who are residents of one or both of the Contracting States.

2. This Agreement shall apply to copyright royalties when they arise in one Contracting State and their beneficiary is a resident of the other Contracting State.

### Article II
*Taxes covered*

*Alternative A*

1. This Agreement shall apply to compulsory taxes or deductions imposed on behalf of each Contracting State, (of its political subdivisions or its local authorities), irrespective of their description, their kind and the manner in which they are levied, provided that they are imposed on copyright royalties and are assessed on the amount of royalties, excluding taxes of a fixed nature calculated without reference to the amount of the royalty.

2. The existing taxes to which the Agreement shall apply are in particular:

a) in (State A)
   (i) [income tax applicable]
   (ii) [other taxes applicable]
   (iii) . . .
b) in (State B)
   (i) [income tax applicable]
   (ii) [other taxes applicable]
   (iii) . . .

3. This Agreement shall apply also to future taxes identical [or substantially similar] to those referred to in paragraph 1, which are imposed after the date of signature of this Agreement in addition to, or in place of, existing taxes.

4. The competent authorities of Contracting States shall communicate [at the

beginning of each year] any changes in their respective laws and their application [made during the preceding year].

*Alternative B*

1. This Agreement shall apply to taxes imposed on behalf of each Contracting State [of its political subdivisions or its local authorities], irrespective of their description or the manner in which they are levied, provided that they are imposed on copyright royalties and are assessed on the amount of the royalties.

2. The taxes to which this Agreement shall apply are:
a) in (State A)
   (i) [total income tax]
   (ii) [other income taxes]
   (iii) ...
b) in (State B)
   (i) [total income tax]
   (ii) [other income taxes]
   (iii) ...

3. The competent authorities of Contracting States shall communicate [at the beginning of each year] any changes in their respective tax laws and their application [made during the preceding year].

## II
## DEFINITIONS

### Article III
*General definitions*

For the purposes of this Agreement, unless the context otherwise requires:
a) the terms "a Contracting State" and "the other Contracting State" shall, depending on the context, refer to (State A) or (State B);
b) the term "person" includes an individual, a company and any other body of persons;
c) the term "company" means any body corporate or any entity which is treated as a body corporate for tax purposes;
d) the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;
e) the term "nationals" means:
   (i) all individuals possessing the nationality of a State;
   (ii) all legal persons, partnerships and associations deriving their status as such from the law in force in a State;
f) the term "competent authority" means:
   (i) in (State A), . . . . . . and,
   (ii) in (State B), . . . . . . ;
g) the term "copyright royalties" shall be interpreted in accordance with the definition given in Article 1 of the Multilateral Convention for the Avoidance of Double Taxation of Copyright Royalties;
h) the term "beneficiary of copyright royalties" shall be interpreted in accordance with the definition given in Article 2 of the Multilateral Convention for the Avoidance of Double Taxation of Copyright Royalties;
i) the term "State of source of royalties" shall be interpreted in accordance with the definition given in Article 4 of the Multilateral Convention for the Avoidance of Double Taxation of Copyright Royalties;
j) the term "State of residence of the beneficiary" shall be interpreted in accordance with the definition given in Article 3 of the Multilateral Convention for the Avoidance of Double Taxation of Copyright Royalties completed by Article IV of this Agreement.

### Article IV
*Resident*

1. For the purposes of this Agreement, a person shall be deemed to be a resident of a State if he is so considered in application of the provisions of Article 3, paragraph 2, of the Multilateral Convention for the Avoidance of Double Taxation of Copyright Royalties.

2. Where by reason of the provision of paragraph 1 an individual is deemed to be a resident of both Contracting States, then his status shall be determined as follows:
a) he shall be deemed to be a resident of the State in which he has a permanent home available to him. If he has a permanent home available to him in both States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (centre of vital interests);
b) if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident of the State in which he has an habitual abode;
c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident of the State of which he is a national;
d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

3. Where by reason of the provisions of paragraph 2 a person other than an individual is deemed to be a resident of both Contracting States, [it shall be deemed to be a resident of the Contracting State in which its place of effective management is situated] [the competent authorities of the Contracting States shall settle the question by mutual agreement].

### Article V
*Permanent establishment — fixed base*

1. For the purposes of this Agreement, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

[2. The term "permanent establishment" includes especially:
a) a place of management;
b) a branch;
c) an office;
d) an industrial installation;
e) a store or other sales outlet;
f) a permanent exhibition at which orders are received or solicited;
g) the furnishing of services, including consultancy services, by an enterprise through employees or other personnel, where activities of that nature continue, for the same or a connected project, in the territory of the same State [for . . . . months].

3. Notwithstanding the provisions of paragraphs 1 and 2, a "permanent establishment" shall not be deemed to include:
a) the use of facilities solely for the purpose of storage or display of goods belonging to the enterprise;
b) the maintenance of a stock of goods belonging to the enterprise solely for the purpose of storage or display;
c) the maintenance of a stock of goods belonging to the enterprise solely for the purpose of processing by another enterprise;
d) the maintenance of a fixed place of business solely for the purpose of purchasing goods, acquiring rights or collecting information for the enterprise;
e) the maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information, for scientific research or for similar activities which have a preparatory or auxiliary character, for the enterprise.

4. Notwithstanding the provisions of paragraphs 1 and 2, a person acting in a Contracting State on behalf of an enterprise of the other Contracting State — other than an agent of an independent status, to whom paragraph 5 applies — shall be deemed to be a "permanent establishment" in the first-mentioned State:
a) if he has, and habitually exercises in that State, an authority to conclude contracts in the name of the enterprise, unless his activities are limited to the purchase of goods, or to the acquisition of rights, for the enterprise; or
b) if he has no such authority but habitually maintains in the first-mentioned

State a stock from which he regularly delivers merchandise on behalf of the enterprise.

5. An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business there through a broker, general commission agent, literary agent, or any other intermediary of an independent status, where such persons are acting in the ordinary course of their business. However, when the activities of such an intermediary are devoted exclusively or almost exclusively to that enterprise for more than . . . consecutive months, he shall not be deemed an agent of an independent status within the meaning of this Article.

6. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of another Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not in itself constitute such a company as a permanent establishment of the other].

7. In this Agreement, the term "fixed base" means a place of residence and of work, or a place of work, where an individual habitually carries on a part at least of his activities of an independent nature.

## III
## RULES OF TAXATION

### Article VI
*Taxation methods*

*1st Alternative*

### Article VI A
*Taxation by the State of residence subject to the existence of a permanent establishment or fixed base in the other State*

1. Copyright royalties arising in a Contracting State and paid to a resident of the other Contracting State shall, subject to the provisions of paragraph 2, be taxable only in that other State if such resident is the beneficial owner of the royalties.

2. The provisions of paragraph 1 shall not apply with respect to taxes on income if the beneficiary of the royalties carries on an industrial or commercial activity in the other Contracting State in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right, activity or property in respect of which the royalties are paid is effectively connected with such permanent establishment or fixed base. In such a case, the royalties may be taxed solely in the State where the permanent establishment or the fixed base is situated, but only to the extent that these are attributed to that establishment or that base.

3. In each Contracting State, the royalties that the beneficiary might have been expected to collect if he had created a distinct and separate enterprise or if he had installed a distinct and separate place of work engaged in the same activities under the same or similar conditions independently of the centre of activity of which this enterprise or this place of work constitutes a permanent establishment or a fixed base, shall be attributed to that permanent establishment or that fixed base. There shall be allowed as deductions expenses directly connected with the copyright royalties and incurred for the purposes of the permanent establishment or fixed base, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment or the fixed base is situated, or elsewhere. The royalties attributed to the permanent establishment or the fixed base shall be calculated by the same method year by year, unless there is good and sufficient reason to the contrary.

[4. If a royalty is more than the normal, intrinsic value of the rights in respect of which it is paid, the provisions in paragraphs 1 and 2 may be applied only to that part of the royalty corresponding to this normal, intrinsic value].

*2nd Alternative*

### Article VI B
*Allocation of taxation between the State of residence and the State of source with the same tax ceiling in both Contracting States*

1. Copyright royalties arising in a Contracting State and paid to a beneficial owner who is a resident of the other Contracting State shall be exempt in the first-mentioned State from the taxes covered under paragraph[s] 2(a)(ii) [and 2(a)(iii)] of Article II in the case of (State A) or under paragraph[s] 2(b)(ii) [and 2(b)(iii)] of Article II in the case of (State B).

2. Where royalties are subject to income tax in the Contracting State of source according to the law of that State and in the Contracting State in which the beneficial owner is resident, the tax so charged may not exceed "x"% of the amount of the royalty in the State of source and "y"% of the gross amount of the royalty in the State of residence.

3. The provisions of paragraphs 1 and 2 shall not apply if the beneficiary of royalties, being a resident of a Contracting State, carries on an industrial or commercial activity in which the royalties arise through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right, activity or property in respect of which the royalties are paid is effectively connected with such permanent establishment or fixed base. In such a case the royalties may be taxed solely in the State where the permanent establishment or the fixed base is situated, but only so much of them as is attributable to that permanent establishment or fixed base.

4. In each Contracting State, the royalties that the beneficiary might have been expected to collect if he had created a distinct and separate enterprise or if he had installed a distinct and separate place of work engaged in the same or similar activities under the same or similar conditions independently of the centre of activity of which this enterprise or this place of work constitutes a permanent establishment or a fixed base, shall be attributed to that permanent establishment or that fixed base. There shall be allowed as deductions expenses incurred for the purpose of the permanent establishment or fixed base, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment or the fixed base is situated, or elsewhere. The royalties attributed to the permanent establishment or the fixed base shall be calculated by the same method year by year, unless there is good and sufficient reason to the contrary.

[5. If a royalty is more than the normal, intrinsic value of the rights in respect of which it is paid, the provisions in paragraphs 1, 2 and 3, may be applied only to that part of the royalty corresponding to this normal, intrinsic value].

*3rd Alternative*

### Article VI C
*Allocation of taxation between the State of residence and the State of source with different tax ceilings in each Contracting State*

1. Copyright royalties whose source is in a Contracting State and paid to a beneficial owner who is a resident of the other Contracting State shall be taxable in both Contracting States. They shall, however, be exempt from the taxes covered by paragraph[s] 2(a)(ii) [and 2(a)(iii)] of Article II in the case of (State A) or in paragraph[s] 2(b)(ii) [and 2(b)(iii)] of Article II in the case of (State B).

2. Where such royalties are subject to income tax in the Contracting State in which they have their source, according to the law of that State, and in the Contracting State of which the beneficiary is a resident, the tax so charged may not exceed:

a) in the case of royalties whose source is in (State A) and paid to a resident of (State B) "x" percent of the gross amount of the royalties in the case of the tax levied in (State A) and "x" percent of the gross amount of the royalties in the case of the tax levied in (State B).
b) in the case of royalties whose source is in (State B) and paid to a resident of (State A) "y" percent of the gross amount of the royalties in the case of the tax levied in (State A) and "y" percent of the gross amount of the royalties in the case of the tax levied in (State B).

3. The provisions of paragraphs 1 and 2 shall not apply if the beneficiary of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right, activity or property in respect of which the royalties are paid is effectively connected with such permanent establishment or fixed base. In such a case the royalties may be taxed solely in the State where the permanent establishment or the fixed base is situated, but only so much of them as is attributable to that permanent establishment or fixed base.

4. In each Contracting State, the royalties that the beneficiary might have been expected to collect if he had created a distinct and separate enterprise or if he had installed a distinct and separate place of work engaged in the same or similar activities under the same or similar conditions independently of the centre of activity of which this enterprise or this place of work constitutes a permanent establishment or fixed base, shall be attributed to that permanent establishment or that fixed base. There shall be allowed as deductions expenses directly connected with the copyright royalties and incurred for the purposes of the permanent establishment or fixed base, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment or the fixed base is situatied, or elsewhere. The royalties attributed to the permanent establishment or the fixed base shall be calculated by the same method year by year, unless there is good and sufficient reason to the contrary.

[5. If a royalty is more than the normal, intrinsic value of the rights in respect of which it is paid, the provisions in paragraphs 1, 2 and 3, may be applied only to that part of the royalty corresponding to this normal, intrinsic value].

*4th Alternative*

**Article VI D**
*Taxation by the State of source*

Copyright royalties whose source is in a Contracting State and paid to a resident in the other Contracting State are taxable exclusively in the State of source of the royalties.

*5th Alternative*

**Article VI E**
*Allocation of taxation between the State of residence and the State of source with the tax ceiling in the State of source*

1. Copyright royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, such royalties may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the recipient is the beneficiary of the royalties, the tax so charged shall not exceed "x" percent of the gross amount of the royalties. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.

*6th Alternative*

**Article VI F**
*Allocation of taxation between the State of source and that of residence with the tax ceiling in the State of residence*

1. Copyright royalties whose source is in a Contracting State and which are paid to a beneficial owner resident of the other Contracting State, shall be taxable in the State of source of the royalties.

2. However, said royalties may also be taxed in the Contracting State where the beneficial owner of the royalties resides, but not to exceed x percent of the gross amount of the royalties.

## IV
## ELIMINATION OF DOUBLE TAXATION

**Article VII**
*Methods for avoidance of double taxation*

*1st Alternative*

**Article VII A**
*Exemption method*

*1st Alternative: Article VII A (i)* — Ordinary exemption

Where a resident of a Contracting State receives royalties which, in accordance with the provisions of Article VI, may be taxed in the other Contracting State, the first-mentioned State shall exempt such royalties from the tax on the income of this resident and shall not take them into account in calculating the amount of this tax.

*2nd Alternative: Article VII A (ii)* — Exemption with progression

Where a resident of a Contracting State receives royalties which, in accordance with the provisions of Article VI, may be taxed in the other Contracting State, the first-mentioned State shall exempt such royalties from the tax on the income of this resident. Such State may nevertheless take into account the exempted royalties in calculating the amount of tax on the other income of this resident and may apply the same rate of tax as if the royalties in question had not been exempted.

*3rd Alternative: Article VII A (iii)* — Exemption maintaining taxable income

Where a resident of a Contracting State receives royalties which, in accordance with the provisions of Article VI, may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from tax on the income of that resident, that part of the tax which is applicable to the royalties received from the other Contracting State.

*2nd Alternative*

**Article VII B**
*Credit method*

*1st Alternative: Article VII B (i)* — Ordinary credit

1. Where a resident of a Contracting State receives royalties which, in accordance with the provisions of Article VI, may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident, an amount equal to the income tax paid in the other Contracting State. Such deduction shall not exceed that part of the income tax, as computed before the deduction is given, which is attributable to the royalties which may be taxed in the other Contracting State.

2. For the purposes of this deduction, the taxes referred to in paragraphs 2(a)(i) and 2(b)(i) of Article II shall be deemed to be income tax.

*2nd Alternative: Article VII B (ii)* — Full credit

1. Where a resident of a Contracting State receives royalties which, in accordance with the provisions of Article VI, may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in the other Contracting State.

2. For the purposes of this deduction, the taxes referred to in paragraphs 2(a)(i) and 2(b)(i) of Article II shall be deemed to be income tax.

*3rd Alternative: Article VII B (iii)* — Matching credit

1. Where a resident of a Contracting State receives royalties which, in accordance with the provisions of Article VI, may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident, an amount equal to .... percent of the gross amount of such royalties, whether or not the amount deducted in the State where the royalties arise equals this percentage.

2. For the purpose of this deduction, the taxes referred to in paragraphs 2(a)(i) and 2(b)(i) of Article II shall be deemed to be income tax.

*4th Alternative: Article VII B (iv)* — Tax sparing credit

1. Where a resident of a Contracting State received royalties which, in accordance with the provisions of Article VI, may be taxed in the other Contracting State and benefit there from special tax relief, the first-mentioned State shall allow as a deduction from the tax on the income of that resident, who is the beneficiary of royalties, an amount equal to the total sum which, without this relief, would have had to be paid in that other State as tax on such royalties.

2. For the purposes of this deduction, the taxes referred to in paragraphs 2(a)(i) and 2(b)(i) of Article II shall be deemed to be income tax.

## V
## MISCELLANEOUS PROVISIONS

### Article VIII
*Non-discrimination*

1. In accordance with the principle of non-discrimination set out in Article 6 of the Multilateral Convention for the Avoidance of Double Taxation of Copyright Royalties, the nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation assessed on the amount of a copyright royalty or any requirement connected therewith, which is other or more burdensome than those to which nationals of that other State in the same circumstances are or may be subjected. Notwithstanding the provisions of Article I, this principle also applies to persons who are not residents of one or both Contracting States.

2. Stateless persons who are residents of a Contracting State shall not be subjected in either Contracting State to any taxation on copyright royalties or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of the State concerned in the same circumstances are or may be subjected.

3. The taxation on copyright royalties to which a permanent establishment of an enterprise of a Contracting State is subjected in the other Contracting State shall not be less favourably levied in that other State than the taxation on the same kind of copyright royalties to which enterprises of that State having the same status for tax purposes and carrying on the same activities are subjected. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

4. Subject to the provisions of [paragraph 4 of Article VI A] [paragraph 5 of Article VI B or VI C], the royalties paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such an enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State.

5. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation assessed on copyright royalties or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

6. The provisions of this Article shall, notwithstanding the provisions of Article II, apply to taxes of every kind and description.

### Article IX
*Mutual agreement procedure*

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Agreement, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under Article VIII (1), to that of the Contracting State of which he is a national. This case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Agreement.

2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution within a period of .... or such extended period as may be communicated by it to the competent authority of the other State, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with this Agreement. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavour to resolve by agreement any difficulties or doubts arising as to the interpretation or application of the Agreement. They may also consult together for the avoidance of double taxation in cases not provided for in this Agreement.

4. The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of paragraphs 1, 2 and 3. When it seems advisable in order to reach agreement to have an oral exchange of opinions, such exchange may take place through a Commission consisting of representatives of the competent authorities of the Contracting States.

### Article X
*Exchange of information*

1. The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Agreement or of the domestic laws of the Contracting States concerning taxes covered by this Agreement in so far as the taxation thereunder is not contrary to the Agreement. The exchange of information is not restricted by Article I of this Agreement. Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities, including courts and administrative bodies, involved in the assessement or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to the taxes covered by this Agreement. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceeding or in judicial decisions.

2. In no case shall the provisions of paragraph 1 be construed so as to impose on a Contracting State the obligation:

a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;
b) to supply information which is not

obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;

c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy (ordre public).

**Article XI**
*Members of diplomatic or consular missions*

Nothing in this Agreement shall affect the fiscal privileges of members of diplomatic or consular missions of the Contracting States as well as of their families, either under the general rules of international law or under the provisions of special conventions.

**Article XII**
*Entry into force*

1. This Agreement shall be ratified and the instruments of ratification shall be exchanged at ............................................ as soon as possible.

2. The Agreement shall enter into force upon the exchange of instruments of ratification and its provisions shall have effect:
a) in (State A) ......................................
b) in (State B) ......................................

**Article XIII**
*Termination*

This Agreement shall remain in force until terminated by a Contracting State. Either Contracting State may terminate the Agreement, through diplomatic channels, by giving notice of termination at least six months before the end of any calendar year after the year . . . . . In such event, the Agreement shall cease to have effect:
a) in (State A) ......................................
b) in (State B) ......................................

**Article XIV**
*Interpretation*

As regards the application of this Agreement by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning which it has under the Multilateral Convention for the Avoidance of Double Taxation of Copyright Royalties or, failing this, under the law of that State.

**Article XV**
*Relations between this Agreement and other treaties on double taxation*

In the event of any difference between the provisions of this Agreement and those of another treaty on double taxation concluded by the Contracting States, the provisions of this Agreement shall take precedence in the relations between these States in matters relating to the taxation of copyright royalties.

# TAX GLOSSARY

by H.W.T. PEPPER *

**SUPERSNAKE** — The European currencies involved in the earlier agreement (see SNAKE IN A TUNNEL) were the German mark, Belgian franc, Austrian schilling, Dutch guilder, Swiss franc, and Luxembourg franc. The proposed European Monetary System (EMS), sometimes known as SUPERSNAKE, would embrace members of the EEC and a few other countries, would involve fixed exchange rates between members, the institution of a Common Market currency called the ECU, and the establishment of a Common Market fund which would be used to support exchange rates which came under pressure, although by joining the members would gain strength for their currencies against those of non-members.

**SUPER TAX** — A tax charged in addition to income tax. The term was formerly used to refer to the tax charged in Britain (from 1909 to 1927) subsequently known as surtax, and has also been used in a similar context, e.g. in India.

**SUPPLEMENTARY TAX** — A tax charged in addition to income tax, particularly in a country with a schedular tax system which charges tax at flat rates on certain types of income. The supplementary tax is usually charged at graduated rates on those with incomes above a certain limit. (See also RESIDENTS' TAX.)

**SURCHARGE** — A tax which is often levied as a percentage addition to existing taxes, usually on a temporary basis. If the additional charge is required upon a more permanent basis, the surcharge will usually be superseded in due course by a revision of the substantive rates of tax. Recent examples of the imposition of surcharges have arisen in the U.S., where a ten percent surcharge was applied to the federal income tax rates (raising the maximum from 70 to 77 percent) during President Johnson's term of office, and an import surcharge imposed in 1971 by President Nixon — both these surcharges having been subsequently cancelled. In Britain, there has also recently been an import surcharge and there is power under the CUSTOMS REGULATOR (q.v.) (a provision which has to be renewed annually by Parliament) by means of which the Treasury may make an order increasing or decreasing the principal revenue duties by up to 10 percent. Holland has similar powers (see REGULATOR TAX).
Two recent examples of further uses of this term in connection with taxation are (a) the surcharge imposed in West Germany in 1970 and 1971, which was actually in the form of a "LOAN" LEVY (q.v.) which the Government pledged would be refunded before 1973; and (b) the additional charge on investment income in Britain from 1973 with the abolition of EARNED INCOME RELIEF (q.v.).

**SURRENDER OF LOSS** — Under U.K. tax law, a company in a GROUP (q.v.) (where one company is a 75 percent subsidiary of another, or both are 75 percent subsidiaries of a third company) or a CONSORTIUM (q.v.), which makes a trading loss may surrender the loss in favour of a "claimant company" in the same group.

**SURTAX** — In the U.K., surtax (formerly called SUPER TAX, q.v.) was applied to income taxpayers with incomes above a certain limit during the period 1909 to 1973. Somewhat different rules applied for the calculation of income for surtax purposes. Both income tax and surtax were replaced by UNIFIED TAX (q.v.) from 1973/74. In the U.S.A. corporations' incomes are subject to NORMAL TAX (q.v.) at 22 percent and to surtax where the income exceeds $250,000 at rates which in recent years have varied from 26 to 30 percent.

## T

**TADPOLE LEASE** — A tax avoidance device whereby an entrepreneur owning business premises grants a lease thereof for a long period, say 60 years, to another person in return for a large premium and a small annual rent. The entrepreneur then rents the premises back on a sub-lease for rental payments which are very high in the first few years (constituting more or less the return of the premium). The object is to obtain enhanced tax deductions in respect of the high initial subrents while avoiding tax (or paying only at capital gains tax rates) on the premium received. Anti-avoidance measures in the U.K. have largely countered this device. (See also LEASE-BACK).

**TAKE-HOME PAY** — An employee's net remuneration after deductions for income tax and other compulsory levies, such as Social Security Contributions (e.g. National Health Insurance) and pension contributions.

**TALENT TAX** — The term was used in the U.K. with regard to moves by the Inland Revenue Department to tax awards made by the Arts Council and other bodies to authors, artists, and poets. It was argued that a tax on such awards was a tax on talent. Such talent awards had not previously been regarded as taxable provided they had not been solicited by the recipient and were not made in return for work done by the recipient for the donor.

**TANGIBLES** — Tangible business assets such as factories, machinery (in Italy *all* fixed assets except land) in general qualify for capital allowances if used in the production of business profits, whereas intangibles in general do not (exceptions may include patent, copyright, or mineral rights). In Holland's V.A.T. law, goods are defined (section 5) as "all *tangible* objects".

**TANTIEME** — Percentage (of profits), bonus, commission, or profits.

**TAX AGENT** — The term "tax agent" may either mean (as, for example, in Australian parlance) a tax adviser who assists the taxpayer to perform his duties under the taxing acts, or may mean the person charged under the taxing acts with collecting tax either by deduction or withholding at source, in the case of an income tax, or as the person required to register and pay the tax in the case of sales taxation.

**TAX AVOIDANCE** — See AVOIDANCE.

**TAX BASE** — See TAXABLE BASE.

[to be continued]

* With the assistance of the staff of the International Bureau of Fiscal Documentation.

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*Management Centre Europe:* International cash management (including: International tax aspects in cash management), London (United Kingdom), December 8-10 (English).

## APRIL 1981

*Management Centre Europe:* Fourth MCE International Tax Conference. Chairman: Prof. J. van Hoorn Jr., Co-Chairman: A.G. Davies C.B.E. Main subjects: Transfer pricing; Government and business views on tax avoidance; Taxation of international leasing;small meeting groups directed by members of the faculty, Munich (German Federal Republic), April 8-10 (English).

## SEPTEMBER 1981

*35th Annual Congress of I.F.A.:* I. Mutual agreement procedure and practice; II. Unilateral measures to prevent double taxation, Berlin (German Federal Republic), September 21-25 (English, French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

Associação Fiscal Portuguesa, Rua das Portas de Santo Antão 90, 1100 Lisbon, Portugal.

Business International Institute/Asia, 301-305 Asian House, One Hennessy Road, Hong Kong.

Confédération Fiscal Européenne, Secrétariat Général (C.F.E.), D-5300 Bonn 1, Dechenstrasse 14, German Federal Republic or Siège Social F-75009 Paris, 9 rue Richepanse (France).

International Fiscal Association (I.F.A.): General Secretariat, Woudenstein, Burgemeester Oudlaan 50, P.O. Box 1738, 3000 DR Rotterdam (Netherlands).

Management Centre Europe, Avenue des Arts 4, B-1040 Brussels (Belgium).

Seminar Services International, 54 rue du Faubourg Saint-Honoré, F-75008 Paris (France).

# CUMULATIVE INDEX 1980 - Nos. 1-6

I. ARTICLES

# Contents

of the August/September 1980 issue

# IFA NEWS

Many national branches of IFA organise meetings throughout the year, sometimes jointly. In past issues of the BULLETIN papers have been published which had been discussed during such meetings and which are of interest to people outside the branches concerned. See, for instance, the issue of February-March, 1980 for papers discussed by the U.S. branch.

## U.S. Branch

This issue contains a paper which Mr. Nathan Boidman, member of the Canadian branch, presented to the fourth annual meeting of the U.S. branch on the interpretation of tax treaties.

## Hong Kong Branch

The following is a report on the activities of this youngest branch of IFA which was officially admitted during the 33rd Congress held in Copenhagen, September 1979:

*February 1, 1980:*
Executive Committee meeting followed by a talk delivered to the branch by Prof. J. van Hoorn Jr. on the use of double taxation agreements.

*March 24, 1980:*
Executive Committee meeting followed by a moot (debate) on the relevance of an English court decision (Sharskey v. Wernher 36TC 275 (HL)) in the Hong Kong context.

*June 10, 1980:*
Executive Committee meeting followed by four talks on the subject of "The current situation relating to the utilisation from overseas of the principal treaty links as it applies to (name of country)".
The four speakers were all visitors to Hong Kong and members of an international tax group and were, in order of speaking:

| | |
|---|---|
| John Avery Jones: | U.K. |
| Raoul Lenz: | Switzerland |
| Maarten Ellis: | Netherlands |
| Sanford Goldberg: | U.S.A. |

In addition to the above, the branch has also made a representation to the Hong Kong Government relating to the introduction of a piece of retrospective legislation.

## Belgo-Luxembourg and French Branches

On March 7, 1980 the members from Belgium, France and Luxembourg met in Brussels to discuss the implication of Article 9 of the Sixth VAT Directive of May 17, 1977. This provision deals with the important issue of the place where, for VAT purposes, services are deemed to be rendered.

The time needed for the preparation of this special Congress issue of the BULLETIN did not allow for a publication not only of the papers submitted by members from the three countries but also of a summary of the discussions. It was felt that all these should be published together. This will be done in the next (October) issue of the BULLETIN, in French, with résumés in English, and preceded by a foreword of Professor Paul Sibille.

## FUTURE CONGRESSES

**Berlin** — The 35th Congress will be held in West-Berlin from September 21 to 25, 1981. The main discussion themes will be: I — *Mutual Agreement — Procedure and Practice;* II — *Unilateral Measures to Prevent Double Taxation.*

**Montreal** — Canada will host the 36th Congress to be held from September 12 to 16, 1982. Subject I is *The Tax Treatment of Interest in International Economic Transactions.* The title of the second main subject is *Taxation of Transportation of Passengers and Goods in International Traffic.*

**Venice** — The Italian branch of IFA has decided to hold the 37th Congress in Venice, probably from October 10 to 14, 1983. The subjects for this Congress are under consideration.

**Buenos Aires** — Dates and subjects for the 38th Congress to be organised by the Argentinian branch have not yet been fixed.

# The Congress of Paris

ALUN G. DAVIES
President of IFA.

It is a great pleasure to introduce the Congress of Paris 1980 to the members of IFA through the pages of the IFA Bulletin which, as Dr. Mitchell Carroll said in the Bulletin in 1950 (Vol. 4, No. 1), is the organ of the association as a whole. (The more is the pity that more members of the association don't subscribe to it; it is excellent value for the money.) It is my fervent wish that the International Bureau of Fiscal Documentation, a daughter organisation born out of IFA, should work more closely with IFA. The Bureau has immense resources in the fiscal field, and it is obvious that its formidable battery of fiscal expertise and documentation should be more extensively used by IFA members for their own benefit.

This is the second occasion that Paris has been the venue for the annual congress of IFA, and I feel sure that the Parisian setting will have all the elegance and éclat that we have learned to expect from our French friends. Not even the fact that we are gathered at Paris to discuss some of the esoteric mysteries of the fiscal world will make the ambience of Paris less attractive.

When I first heard that the first subject to be discussed at the Paris Congress was "*the dialogue between the tax administration and the taxpayer up to the filing of the tax return*", my heart fell. I felt like the prophet Ezekiel when he had the vision of the Valley of Dry Bones. Like Ezekiel, I saw a valley full of bones, and they were very dry. I said to myself, can these bones live? Can breath be entered into them, and can sinews and flesh be put upon them? My base expectations have been upset. Monsieur Delorme has breathed upon the dry bones and brought life into them. "*And they stood up upon their feet, an exceedingly great army.*" M. Delorme, formidably backed up by some very good national reports, has introduced life into what could have been a very barren subject indeed. I am intrigued that he should have referred to the relationship between the taxpayer and the fisc as a dialogue. I regret to say that it has often seemed to me to be a dialogue between two deaf persons. The taxpayer has often not wished to hear the words, not perhaps of comfort, but of explanation, from the fisc. He has imagined that the words issuing from the fisc are not "*come unto me all ye that are heavy laden with taxes, and I will help you with your burdens*" but something more tiberian like "*render unto Caesar*".

Apart from this unfortunate lack of liaison, there are many, many in the Valley of Dry Bones who are tax-wraiths, unable and unwilling to participate in any kind of dialogue with the fisc, suspecting, if I may change the metaphor, that the Judas-lamb they are invited to follow will lead them into a tax slaughterhouse, rather than to the promised land. I refer of course to the vast numbers of taxpayers who are members of the black economy, who wish for nothing better than total ignorance of the fisc and its propensity to invite them to participate voluntarily in the process of extraction.

The British national report is itself something of a surprise, because it is written in collaboration between a high official in the Board of Inland Revenue and one of the leaders of the accounting profession in the United Kingdom. The opening words of the British report, quoting Edmund Burke as saying "*to tax and to please... is not given to men*" summarises only too well the minefields which exist in this controversial area.

The second subject at Paris "*the rules for determining income and expenses as domestic or foreign*" is poles apart from the first subject. The problems of the determination of source, and the subsequent tax treatment of a source, are fundamental in many national tax systems. The variations in the concept of source from country to country bring in their trail two unfortunate consequences, the first is that double taxation is likely to ensue, and the second is that the variations are a natural and fertile source of tax avoidance. The purpose of international tax treaties is a twin one, to avoid double taxation and to prevent tax avoidance. They have not wholly succeeded on either count.

Apart from the two subjects which have been published in the Cahiers of the Paris Congress, and which will form the basis of our discussions, there are two seminars. The first is on a subject which attracts debates in so many tax conferences, like moths attracted to a candle — *the use and abuse of tax havens.* I would have thought that we had heard the last words on this subject, but no, we come back to it again with the addiction of an alcoholic to the bottle. This is not to say that the subject is without its fascinations. It certainly has, and we shall play with it again, like children playing with fire.

The second seminar, on the *French fiscal system*, should be very fascinating. The French have given the European Community the imputation system in direct taxation, and the TVA in the world of indirect taxation. It is an achievement for the French to have won acceptance for both the main instruments of taxation in the direct and indirect taxation fields. I must confess that when the French Government introduced imputation in 1965 just as the British Government dumped it after a century and a half, I had a strange foreboding that one of them was very wrong. Well, the British returned to imputation in 1972 and the classical system walls of the British fiscal Jerusalem built by James Callaghan in 1965 were destroyed by the successor parliament. The prophecies of the British equivalent of Tobias and Sanballat proved to be too true.

Our French hosts are offering a fiscal feast at the Congress of Paris. I hope it will be as acceptable as the gastronomical delights of the city undoubtedly will be.


Cette photo est reproduite avec l'autorisation du propriétaire, le Palais des Congrès de Paris.

# Quelques Aspects Originaux de la Fiscalité Française

PAR MAURICE PAPON

MAURICE PAPON,
Ministre du Budget

*Né le 3 septembre 1910, à Gretz (Seine-et-Marne), M. Maurice PAPON après des études supérieures de droit, d'économie et de sciences politiques et de sociologie (Diplôme d'études supérieures de droit public et d'économie politique, Diplôme de l'Ecole Libre des Sciences Politiques), est entré en 1935 au Ministère de l'Intérieur.*

*Nommé Préfet en 1944, les principales étapes de sa carrière sont les suivantes:*

*Préfet des Landes (1944), de la Corse (1947), de Constantine (Algérie 1949), Secrétaire Général du Protectorat du Maroc (1954-1955), Igame de la région de l'Est Algérien, Préfet de Constantine (1956-1958), Préfet de Police de Paris (Mars 1958 à décembre 1966). M. PAPON a également à diverses reprises assumé des fonctions dans des cabinets ministériels.*

*En 1967-1968, il est Président Directeur Général de Sud-Aviation.*

*Elu député du Cher (3ème circonscription: Saint-Amand) en juin 1968 il sera constamment réélu depuis (mars 1973 et mars 1978). Il est Maire de Saint-Amand Montrond depuis 1971. A l'Assemblée Nationale où il siège, M. Maurice PAPON est inscrit au Groupe de l'Union des Démocrates pour la République (U.D.R.), mouvement dont il fut le Trésorier National, puis au Groupe du Rassemblement pour la République (R.P.R.).*

*Après avoir été Président de la Commission des Finances de l'Assemblée Nationale (1972), il est Rapporteur Général de cette Commission de 1973 à 1978.*

*Il est, depuis le 5 avril 1978, Ministre du Budget dans le 3ème Cabinet de M. Raymond BARRE.*

*Ouvrages publiés:* *"L'Ere des responsables" — 1954.*
*"Vers un nouveau discours de la méthode" — 1965.*
*"Le Gaullisme ou la loi de l'effort" — 1973.*

La présentation de l'ensemble d'un régime fiscal nécessiterait de trop longs développements qui n'auraient pas leur place dans les dimensions d'un article sauf à procéder à des "raccourcis" par trop simplificateurs. C'est pourquoi il m'a semblé que c'étaient les aspects originaux de notre législation qui étaient les plus susceptibles d'intéresser les lecteurs étrangers. La France, en effet, a souvent joué un rôle novateur en matière fiscale puisque, par exemple, dans deux domaines essentiels — la taxe sur la valeur ajoutée et l'avoir fiscal — les règles mises au point dans notre pays tendent à se généraliser dans la plupart des Etats européens.

Après avoir rappelé la spécificité de la structure de nos prélèvements obligatoires, je m'attacherai aux principales particularités de la législation française. Je mettrai enfin l'accent sur quelques mesures nouvelles d'adaptation de la fiscalité aux nécessités économiques.

## 1) EVOLUTION ET STRUCTURE DES PRELEVEMENTS OBLIGATOIRES EN FRANCE

La France, comme tous les pays industrialisés, a connu ces dernières années une croissance sensible des prélèvements obligatoires. Toutefois, cette croissance globale recouvre des évolutions assez différentes voire divergentes selon la nature des prélèvements qui reflètent la multiplication des interventions publiques et des opérations de transfert nécessitées par la situation économique.

### a) Progression globale des prélèvements obligatoires moins rapide que celle de ses partenaires

De 1975 à 1980, l'ensemble des prélèvements obligatoires français est passé de 37,4 pour cent du Produit intérieur brut (P.I.B.) à 41,6 pour cent. Cette augmentation a cependant été nettement moins rapide que dans beaucoup d'autres pays. En effet, en 1965, la France venait au 3ème rang des pays de l'O.C.D.E. après la Suède et les Pays-Bas, pour l'importance de ses prélèvements obligatoires par rapport à son P.I.B. Selon le même critère, elle n'était plus qu'en 6ème rang en 1976 et au 8ème rang en 1977-1978.

Malgré cette évolution, la France continue à présenter un poids de prélèvements obligatoires supérieur à celui de ses principaux partenaires commerciaux, ainsi qu'en témoigne le tableau suivant:

**Total des prélèvements obligatoires en pourcentage du produit intérieur brut en 1978**

| *France* | *Allemagne fédérale* | *Etats-Unis* | *Italie* | *Royaume-Uni* |
|---|---|---|---|---|
| 39,4 | 38 | 30,4 | 34,5 | 35,2 |

## b) La structure des prélèvements obligatoires

La fiscalité ne représente en France qu'un peu plus de la moitié des prélèvements obligatoires. Le poids des cotisations sociales est en effet un des plus élevés des pays de l'O.C.D.E. et, au cours des années récentes, ce sont ces cotisations qui ont été responsables de la croissance des prélèvements obligatoires. Leur montant est passé de 12,9 pour cent du P.I.B. en 1970 à 18 pour cent en 1980. Cette particularité explique pour partie la relative faiblesse de la part de l'impôt sur le revenu en France, par rapport à de nombreux pays étrangers, puisque les cotisations sociales peuvent être assimilées à un impôt direct assis sur les rémunérations et prélevé par voie de retenue à la source.

Au cours de la même période 1970-1980, le prélèvement fiscal global est resté de l'ordre de 23 pour cent du P.I.B. Encore faut-il observer que cette stabilité de la fiscalité recouvre elle-même deux phénomènes de sens opposé: une diminution d'un point du P.I.B. de la fiscalité d'Etat, de 1970 à 1980, qui a été compensée par une augmentation équivalente de la fiscalité locale.

## c) Le rééquilibrage entre impôts directs et indirects

Enfin, à l'intérieur des impôts d'Etat, le partage entre fiscalité directe et indirecte a beaucoup évolué depuis une quinzaine d'années, la part de ces derniers ne cessant de diminuer.

Certes, par rapport à plusieurs de ses principaux partenaires commerciaux, la France reste un pays à forte fiscalité indirecte. Le tableau qui suit montre cependant l'ampleur du rééquilibrage intervenu:

| | *1962* | *1970* | *1975* | *1979* |
|---|---|---|---|---|
| Impôts directs | 28,5 | 33,3 | 34,9 | 37,2 |
| Impôts indirects | 71,5 | 66,6 | 65,1 | 62,8 |
| Total de recettes fiscales d'Etat | 100 | 100 | 100 | 100 |

Au total, la taxe sur la valeur ajoutée fournit encore à l'Etat français la moitié de ses recettes; toutefois, plusieurs abaissements de ses taux ont déjà permis de réduire sensiblement la part de cet impôt dans les recettes fiscales. Ainsi, début 1973, le taux normal de la T.V.A. passait de 23 pour cent à 20 pour cent et le taux réduit de 7,5 pour cent à 7 pour cent. Début 1977, le taux normal était ramené de 20 pour cent à 17,60 pour cent. En outre, le taux applicable à plusieurs produits de consommation courante a été abaissé: les produits pharmaceutiques et les transports en commun de voyageurs ont ainsi pu bénéficier de taux réduit de T.V.A.

En dehors de cette action volontariste, la réduction des impôts indirects trouve aussi son origine dans l'absence d'indexation systématique, sur le niveau général des prix, de certains droits indirects fixés en valeur absolue. Or, d'une part, il est difficile de demander chaque année au Parlement de relever les barèmes de certaines accises. D'autre part, lorsqu'un relèvement intervient, il ne s'agit généralement que d'un rattrapage, avec un certain retard, de l'indice général des prix.

En sens inverse, l'impôt sur le revenu a connu une très forte croissance puisqu'il représente 25,4 pour cent des recettes fiscales de l'Etat en 1980 contre 18,1 pour cent en 1970. Sans doute cette augmentation est-elle pour partie imputable à une sous-indexation volontaire des tranches les plus élevées du barème. Mais, en dehors de toute sous-indexation, la progression de l'impôt sur le revenu a surtout correspondu, au cours de la décennie écoulée, à la croissance du revenu réel des français.

En effet, du fait de la progressivité de l'impôt, toute augmentation du revenu se traduit par un accroissement plus que proportionnel de l'impôt. La structure du barème français est telle que le produit de l'impôt croît en moyenne deux fois plus vite que les revenus déclarés.

# 2) QUELQUES PARTICULARITES DE LA LEGISLATION FRANÇAISE

Si la structure des prélèvements obligatoires demeure en France assez différente de ce qu'elle est dans les pays voisins, le législation fiscale comporte également des particularités.

Je retiendrai tout d'abord les principales originalités de l'impôt sur le revenu français: quotient familial et absence de retenue à la source. Puis j'aborderai les modalités spécifiques d'imposition des petites ou moyennes entreprises et je présenterai enfin les pouvoirs dont dispose l'administration française pour lutter contre la fraude et les garanties données aux contribuables.

## a) Les originalités de l'impôt sur le revenu

### (i) Le quotient familial

La Déclaration des Droits de l'Homme et du Citoyen de 1789 proclame le droit à l'égalité des citoyens devant l'impôt, selon leurs facultés. Le système français d'impôt sur le revenu considère que cette faculté contributive doit être appréciée au niveau de chaque cellule familiale. L'impôt s'applique donc aux revenus globaux d'un foyer, mais sa progressivité est atténuée par le jeu du quotient familial qui consiste à appliquer le barème au revenu moyen dont dispose chaque membre de l'unité familiale.

Ce mécanisme procure des avantages appréciables aux familles ayant la charge d'enfants et il constitue d'ailleurs l'un des principaux instruments de la politique familiale.

Ce n'est toutefois pas son unique objet puisque le quotient familial est également un quotient conjugal. La France ignore, sauf exception, l'imposition séparée des époux.

En pratique, le revenu total imposable du foyer fiscal est divisé par un nombre de parts qui reflète les charges de famille ou la situation particulière du foyer. [1] Chacune de ces parts de revenus est imposée selon le barème progressif. L'impôt total exigible correspond à la somme des impôts applicables à chaque part.

Prenons l'exemple d'un ménage comprenant 4 enfants et ayant donc droit à 4 parts de quotient familial qui a perçu 80.000 Fr.Frs. de revenus nets imposables en 1979.

Le barème progressif de l'impôt est appliqué au revenu global divisé par le quotient familial, soit 20.000 Fr.Frs., ce qui donne un impôt par part de 1.710 Fr.Frs.

L'impôt total dû part le ménage sera donc de: 1.710 x 4 = 6.840 Fr.Frs., ce qui équivaut au total des impôts que devraient payer 4 célibataires ayant perçu chacun 20.000 Fr.Frs. de revenus, mais ce qui est largement inférieur aux 24.293 Fr.Frs. d'impôt dûs par un célibataire ayant eu des revenus de 80.000 Fr.Frs.

### (ii) La perception de l'impôt par voie de rôle

La seconde caractéristique assez originale de l'impôt sur le revenu français tient à son mode de perception. A la différence de nombreux pays étrangers, la France ne recouvre pas, en règle générale, l'impôt par voie de retenue à la source.

Même s'ils ne perçoivent que des salaires, les contribuables français doivent eux-mêmes déclarer chaque année leurs revenus de l'année précédente et acquitter l'impôt correspondant qui est calculé par l'administration fiscale.

En raison du délai nécessaire pour accomplir ces diverses opérations, il existe un décalage important entre l'encaissement des revenus et le versement de l'impôt correspondant.

Ainsi, quel que soit le système de versement adopté par les contribuables, ce n'est en principe pas avant septembre-octobre 1980 que les revenus perçus en 1979 seront effectivement imposés.

En revanche, les cotisations sociales, dont l'importance a été soulignée au début du présent article, sont retenues à la source par les employeurs.

## b) Les modalités d'imposition des petites ou moyennes entreprises

La France a toujours cherché à préserver ses petites ou moyennes entreprises qui maintiennent une vie économique dans les 36.000 communes du territoire national. Mais elle le fait d'autant plus volontiers depuis le début de la crise que ce sont les entreprises de taille modeste qui s'avèrent les plus capables de créer des emplois.

Les principales originalités de la législation fiscale concernent le régime du forfait et certaines mesures récentes destinées à améliorer la gestion des petites entreprises.

Le régime du forfait industriel et commercial s'applique aux contribuables dont le chiffre d'affaires annuel est inférieur, en principe, à 500.000 Fr.Frs. Alors que les régimes réels d'imposition obligent les contribuables à déclarer à l'Administration leurs résultats calculés à partir d'une comptabilité complète, le régime du forfait se caractérise par une intervention a priori de l'Administration dans l'évaluation du bénéfice. Celui-ci est fixé lors d'une négociation avec le contribuable qui n'est tenu de fournir qu'une déclaration très simplifiée comportant essentiellement les achats. La négociation a pour objet de déterminer la marge nette applicable à ces achats, compte tenu des marges habituellement pratiquées par la profession et des particularités éventuelles de l'entreprise.

Le forfait a le mérite de permettre aux plus petites entreprises de payer l'impôt sans sujétion excessive ni pour le contribuable ni pour l'Administration. Il concerne encore actuellement plus d'un million de contribuables, mais ce nombre tend à diminuer sous les effets conjugués du non relèvement des limites de chiffres d'affaires, fixées voici plus de dix ans, et des incitations offertes pour l'adoption d'autres régimes d'imposition.

En effet, bien que des recoupements aient démontré que le régime forfaitaire permet globalement de cerner d'assez près les résultats réels, il n'exige pas la tenue de documents comptables suffisants pour assurer une gestion correcte.

C'est pourquoi les pouvoirs publics ont mis en place, depuis 1974, un système qui permet aux entrepreneurs individuels et aux travailleurs non salariés de bénéficier d'avantages équivalents à ceux réservés auparavant aux salariés tout en améliorant la gestion de leur entreprise. Les salaires sont en effet imposés après un abattement de 20 pour cent qui est justifié par la bonne connaissance de ce type de revenus qui est déclaré par des tiers. Un tel avantage ne pouvait être accordé aux petits entrepreneurs en raison de l'imprécision qui entachait jusqu'ici la connaissance de leurs revenus. Afin de rapprocher les conditions d'imposition des salariés et des non salariés, ces derniers ont été autorisés à adhérer à des organismes agréées par l'administration fiscale. Ces organismes, appelés centres de gestion agréés, apprécient la sincérité de la comptabilité de leurs adhérents qui doivent obligatoirement être soumis à un mode réel d'imposition.

Ces diverses obligations permettent d'accorder aux adhérents un abattement de 20 pour cent sur leur bénéfice imposable, équivalent à celui dont bénéficient les salariés. D'une façon plus générale, toutes les professions dont les revenus sont déclarés ou contrôlés par des tiers possèdent désormais des avantages analogues.

Enfin, l'aide aux petites et moyennes entreprises revêt également la forme de systèmes devant faciliter la création d'entreprises nouvelles.

1. En règle générale: 1 part pour chaque conjoint + 1/2 part par enfant à charge. Un célibataire a donc une part, un ménage sans enfant 2 parts, et, par exemple, un ménage avec 4 enfants 4 parts.

Les petites et moyennes entreprises peuvent ainsi se voir accorder une exonération totale de leurs bénéfices réinvestis au cours de l'année de leur création et des deux années suivantes.

Elles peuvent aussi bénéficier — mais cette mesure ne se cumule pas avec la précédente — d'un abattement limité au tiers de leurs résultats, pour l'année de leur création et les quatre années suivantes.

### c) Les moyens de lutte contre la fraude et les garanties des contribuables

L'équité d'un système fiscal n'exige pas seulement que les règles d'établissement de l'impôt soient justes, mais encore qu'elles soient respectées. Le contrôle de l'impôt constitue donc un des objectifs essentiels de l'administration fiscale française qui se voit reconnaître par la loi des pouvoirs très importants.

L'évolution de ces dernières années a été marquée par un double mouvement:

— en renforcement des moyens de lutte contre la fraude,
— et un renforcement des garanties des contribuables.

#### (i) Des moyens de lutte renforcés

En premier lieu, le droit de communication de l'administration française est très étendu, il porte sur tous les documents comptables et pièces annexes des industriels et commerçants et de la plupart des professions libérales. Ce droit de communication est assorti des restrictions nécessaires à la protection de toutes les informations couvertes par le secret professionnel telles que celles que peuvent détenir des médecins sur leurs malades. Cette communication a pour objet, non de contrôler l'entreprise qui détient ces documents, mais d'obtenir des informations sur les opérations réalisées par des tiers.

En outre, tous les établissements financiers ont l'obligation de déclarer à l'administration les ouvertures et clôtures de comptes. Cette formalité peut être désormais accomplie de façon automatisée, par la simple communication de bandes magnétiques, ce qui est un gage de rapidité et d'efficacité. Sur requête des fonctionnaires de l'administration fiscale, les établissements bancaires doivent également présenter le détail des opérations réalisées par certains de leurs clients. L'administration peut ainsi, à partir des opérations financières réalisées par un contribuable, déterminer quelles ont été ses dépenses et ses recettes et tenter de reconstituer ce que fut son revenu réel.

Afin de restreindre encore davantage les possibilités de fraude lors de paiements par chèque, une loi récente a assujetti les carnets de chèques non barrés et endossables à un droit de timbre spécial. Surtout, l'administration fiscale peut désormais obtenir à tout moment communication de l'identité des personnes auxquelles les formules de chèque non barrées ont été délivrées. Enfin, les adhérents de centres de gestion et associations agréés sont tenus d'accepter le paiement par chèques non endossables rédigés à leur nom et ils doivent informer leur clientèle de cette obligation.

Les contribuables dont le train de vie est manifestement disproportionné par rapport aux revenus qu'ils déclarent peuvent se voir imposés soit d'une façon forfaitaire, en fonction d'un barème appliqué aux principaux "signes extérieurs" de leur richesse (résidence, automobiles, bateaux, domestiques), soit d'après leurs dépenses notoires. Cependant, cette procédure doit revêtir un caractère exceptionnel et elle n'est utilisée par l'administration qu'en cas de forte présomption de fraude, ce qui représente cependant plusieurs centaines de cas chaque année.

Les services fiscaux disposent également de moyens substantiels pour combattre la fraude des entreprises. Plusieurs mesures ont pour objet de limiter le gonflement des frais généraux. Les entreprises doivent fournir chaque année à l'administration un relevé détaillé de certaines catégories de frais qui comprennent notamment les rémunérations les plus importantes, les frais de réception, les frais de voyage et les cadeaux. De plus, c'est à l'entreprise qu'il appartient de démontrer que toutes ces dépenses ont été engagées dans l'intérêt direct de son exploitation.

Mais la lutte contre la fraude doit de plus en plus prendre la mesure des aspects internationaux. Là aussi un net renforcement des moyens vient renforcer le développement de la coopération internationale.

L'administration française peut ainsi refuser la déduction de toute somme versée à une personne physique ou morale établie dans un paradis fiscal au titre de licences, brevets ou services rendus lorsque l'entreprise française n'apporte pas la preuve que ces dépenses correspondent à des opérations réelles et qu'elles ne présentent pas un caractère exagéré.

Enfin, deux mesures récentes devraient entraver certaines formes d'évasion fiscale internationale. L'une permet à la France d'imposer les bénéfices réalisés par certaines entreprises sous le couvert de filiales ayant leur siège dans un paradis fiscal; l'autre assouplit les conditions permettant de soumettre à l'impôt français des sommes versées à l'étranger au titre de services rendus en France.

#### (ii) Des garanties accrues pour les contribuables

Mais, ainsi que Montesquieu l'observait fort justement: "C'est une expérience éternelle que tout homme qui a du pouvoir est porté à en abuser: il va jusqu'à ce qu'il trouve des limites... Pour qu'on ne puisse abuser du pouvoir, il faut que, par la disposition des choses, le pouvoir arrête le pouvoir". Le renforcement des moyens dont dispose l'administration fiscale pour prévenir et sanctionner la fraude a donc été parallèlement complété par un développement des garanties accordées aux contribuables. Les conditions permettant la taxation d'office ont été précisées; c'est à l'administration qu'il appartient désormais de prouver le caractère intentionnel d'une fraude; un certain nombre de pouvoirs ont été transférés de l'administration fiscale aux tribunaux.

Par ailleurs en 1976, a été créée la charte du contribuable vérifié qui rappelle aux contribuables tous leurs droits et leur est envoyée avec l'avis de vérification.

Surtout, depuis 1978, les contribuables ne peuvent plus être poursuivis pénalement pour fraude fiscale que sur avis conforme d'une commission indépendante de l'administration fiscale. En outre, un comité, composé de hauts magistrats, supervise le contentieux fiscal et, en particulier, émet un avis sur toutes les remises de pénalités excédant un certain montant.

Ceci résulte de la loi sur les garanties des contribuables (1971) qui contient de nombreuses autres mesures notamment pour ce qui est des rectifications d'office, des notifications préalables indispensables.

Ce double mouvement — moyens renforcés et garanties accrues — peut apparaître contradictoire. Il est en fait dans mon esprit, parfaitement complémentaire. L'administration doit être mise à même de disposer des moyens pour faire face à des agissements qui s'apparentent au vol. L'immense majorité des citoyens qui ne fraudent pas ne doit pas avoir à pâtir de ces pratiques puisque ce sont eux qui sont appelés à compenser ces défaillances.

Les garanties renforcent l'impact psychologique de la lutte contre la fraude. Elles évitent tout phénomène de rejet et lui permettent donc de se dérouler efficacement. En quelque sorte, il faut peu à peu arriver à un système où le contrôle devient normal et la fraude anormale.

## 3) L'ADAPTATION DE LA FISCALITE AUX BESOINS DU DEVELOPPEMENT ECONOMIQUE

L'ampleur de la crise économique que connaît le monde développé a suscité, en France comme ailleurs, diverses mesures d'adaptation de la fiscalité aux nouveaux besoins de l'économie.

Les dispositions les plus originales introduites dans notre législation concernent le soutien de l'investissement et le développement de l'épargne affectée au financement du secteur productif.

### a) Le renforcement des mesures en faveur de l'investissement

La législation fiscale française est de manière permanente favorable à l'investissement, tant par l'existence d'un système d'amortissement dégressif que par une appréciation très libérale des durées d'amortissement. Les nécessités de la conjoncture ont cependant conduit à renforcer l'incitation à l'investissement.

Dès 1975, pour compenser les effets dépressifs de la première flambée des prix du pétrole sur le volume des investissements, les pouvoirs publics ont institué une aide fiscale égale à 10 pour cent du prix des nouveaux équipements. Certes, ce type de mesure a souvent été pratique à l'étranger, mais généralement sous la forme d'une déduction opérée en fin d'année sur les bénéfices. Au contraire, l'aide de 1975 était immédiatement imputable sur la taxe sur la valeur ajoutée due par les entreprises.

Toutefois, s'appliquant à tous les investissements commandés entre avril 1975 et janvier 1976, cette aide présentait l'inconvénient de bénéficier à de nombreux équipements qui auraient été acquis, en tout état de cause. Son efficacité n'était donc pas à la mesure de son coût.

Tirant les conséquences de cette expérience, une loi de juillet 1979 a institué un nouveau dispositif de soutien à l'investissement qui constitue, semble-t-il, une première mondiale.

Ce mécanisme permet en effet aux entreprises de bénéficier d'une déduction fiscale, non plus sur la masse totale de leurs nouveaux équipements, mais sur l'accroissement net de leurs investissements par rapport à l'année précédente. Cette aide a ainsi permis aux entreprises de déduire de leurs résultats 10 pour cent de l'excédent de l'investissement net réalisé en 1979, par rapport à l'investissement net de 1978, et elle s'applique de la même façon en 1980.

D'autre part, les coefficients qui permettent de passer de l'annuité d'amortissement linéaire à l'annuité d'amortissement dégressif sont utilisés à des fins conjoncturelles et structurelles. C'est ainsi que les coefficients ont été majorés d'un demi point pour les biens acquis ou fabriqués en 1977. Cette majoration a été rendue permanente pour les matériels permettant soit de lutter contre la pollution, soit de récupérer ou d'économiser l'énergie et les matières premières.

Enfin, depuis 1979, les matériels affectés à la recherche acquis par les petites et moyennes entreprises peuvent faire l'objet la première année d'un amortissement exceptionnel de 50 pour cent, la valeur résiduelle étant au cours des années suivantes amortie selon le mode dégressif.

### b) Une panoplie étendue de mesures en faveur de l'épargne

Le nombre des mesures fiscales en faveur de l'épargne dépasse la vingtaine, ce qui constitue certainement en soi une originalité.

La simple lecture du tableau suivant, qui ne comprend que les principaux avantages, rendra compte de la diversité de ces mesures et du coût important qu'elles représentent pour le budget de l'Etat en tant que "moins values" fiscales.

Cependant, il est apparu que la plupart de ces mesures, dont plusieurs parmi les plus coûteuses pour le budget de l'Etat, bénéficiaient à l'épargne courte et au logement, et non pas à l'épargne longue orientée vers le secteur productif.

Or, l'insuffisance des fonds propres constitue en France l'un des obstacles les plus importants au développement des entreprises et, par suite, à la promotion de l'emploi.

Le législateur français s'est donc efforcé, depuis plusieurs années de réorienter les avantages fiscaux accordés à l'épargne en réduisant ceux bénéficiant au logement ou à l'épargne courte et en développant parallèlement ceux favorisant l'épargne longue.

Ce redéploiement a notamment consisté à réduire la déduction forfaitaire applicable aux revenus des immeubles et à majorer sensiblement les taux du prélèvement libératoire d'impôt sur le revenu applicable aux produits de placements à revenu fixe.

## PRINCIPAUX AVANTAGES FISCAUX ACCORDES A L'EPARGNE

| *Nature de la mesure* | *Estimation du coût de la mesure en 1980, au titre des revenus de 1979 (en millions de Fr.Frs)* |
|---|---|
| EPARGNE OU A COURT TERME | |
| o Exonération des intérêts correspondant aux sommes déposées sur certains livrets et comptes (caisses d'épargne, Crédit Mutuel etc. . .) | 6.650 |
| o Prélèvement libératoire sur les produits des placements à revenu fixe | 1.120 |
| EPARGNE LONGUE | |
| o Prélèvement libératoire sur les produits de placements à revenu fixe | 830 |
| o Avoir fiscal attaché aux dividendes de sociétés françaises (personnes physiques) | 1.900 |
| o Abattements sur les produits de certains placements | 1.160 |
| o Détaxation du revenu investi en actions de sociétés françaises | 1.600 |
| o Déduction des primes d'assurance-vie | 1.200 |
| LOGEMENT | |
| o Aide fiscale accordée par l'Etat aux propriétaires qui logements donnés en location: | |
| – déduction forfaitaire sur les revenus fonciers | 1.000 |
| – déduction des frais divers liés à ces logements | 2.400 |
| o Aide fiscale accordée par l'Etat aux propriétaires qui se logent eux-mêmes: | |
| – déduction de certaines charges concernant l'habitation principale (intérêts d'emprunt, dépenses d'isolation thermique. . .) | 3.700 |

En contrepartie, une loi de juillet 1978 a institué plusieurs mesures originales destinées à orienter l'épargne vers le financement des entreprises.

D'une part, cette loi permet aux sociétés cotées en bourse qui se constituent ou qui procèdent à des augmentations de capital entre le 1er janvier 1977 et le 31 décembre 1981 d'inclure dans leurs charges d'exploitation les dividendes versés aux actions ainsi émises, pendant 7 exercices s'il s'agit d'actions ordinaires et pendant 10 exercices s'il s'agit d'actions à dividende prioritaire sans droit de vote. Cette disposition équivaut, d'une façon certes temporaire, à un avoir fiscal de 100 pour cent pour les actions ainsi émises.

D'autre part, la loi encourage les épargnants à acquérir des actions puisqu'elle permet aux contribuables ayant un domicile fiscal en France de déduire de leur revenu imposable, sous certaines conditions, les sommes nouvellement investies en actions dans la limite annuelle de 5.000 Fr.Frs., majorable en fonction des charges de famille.

Le marché financier français bénéficie d'un net regain d'intérêt depuis la mise en oeuvre de cette loi.

* * *

L'exposé de quelques particularités de notre système fiscal montre qu'imagination et fiscalité peuvent faire bon ménage. Ainsi que je l'ai montré, il ne s'agit pas uniquement d'un legs du passé puisque nous avons continué à introduire de nombreuses innovations dans notre législation au cours des dernières années.

Cependant, il convient maintenant de s'attacher à une bonne application de la législation plutôt que d'ajouter de nouvelles réformes à celles qui n'ont pas encore eu le temps d'être parfaitement assimilées.

Une pause fiscale paraît souhaitable.

Celle-ci doit revêtir un double aspect.

Elle doit tout d'abord consister à stabiliser le poids des prélèvements obligatoires qui ne pourrait continuer à s'accroître au rythme de ces dernières années sans risquer de susciter des réactions de rejet de l'impôt analogues à celles qu'ont connues certains pays dans un passé récent.

En second lieu, il convient de marquer une halte dans le foisonnement législatif qui a apporté chaque année une cinquantaine de dispositions nouvelles au code général des impôts. Cette instabilité législative s'oppose en effet à une bonne compréhension du système fiscal par les contribuables et à sa bonne application par l'administration.

Pour autant, cette pause fiscale ne doit pas être synonyme d'immobilisme. J'entends, en particulier, que l'administration fiscale française mette à profit ce répit législatif pour développer, notamment tant sur le plan interne qu'en coopération avec les administrations étrangères, la lutte contre la fraude et l'évasion fiscales.

Dans la période difficile que traversent nos économies, l'acceptation des efforts demandés à l'ensemble de la population exige en effet une répartition equitable du prélèvement fiscal.

# FRANCE: A Survey of Its Tax System

by D.A. van Waardenburg *

## I. INTRODUCTION

*In the preceding article the French Minister of the Budget, Mr. Maurice Papon, explains the originality of a number of aspects of French tax legislation.*

*The present article, written on the occasion of the 34th congress of IFA in Paris, describes some of these aspects as they appear in the most important French taxes, with a view to giving our non-French readers a bird's eye view of the French tax system as it is today. It is largely based on information published in our loose-leaf publication, SUPPLEMENTARY SERVICE TO EUROPEAN TAXATION. Of course, a brief survey is necessarily incomplete so that the reader who wants more detailed information is referred to the books and articles listed in the selected bibliography published at the end of this article. French taxes are generally categorized in the following manner:*

*I. Direct taxes*

*A. Individual income tax.*
*B. Corporate income tax.*
*C. Miscellaneous taxes levied by the Central Government, mostly payroll taxes.*
*D. Local taxes, including various real property taxes and the business tax.*

*II. Indirect taxes*

*A. Value added tax.*
*B. Excise on, inter alia, alcoholic beverages, wine, theatrical performances, etc.*
*C. Miscellaneous taxes (on bank credits, forestry products and the "para-fiscal" taxes).*

*III. Registration and stamp taxes*

*These include taxes levied at the transfer of real property, capital contribution tax at the creation of a company and inheritance and gift tax.*

### INVESTMENT INCOME RELIEF

Individual taxpayers receive important incentives for investment. The most important are:

(a) Dividends received from a French corporation entitle the shareholder to a credit (avoir fiscal) of one-half of the dividend.
(b) Dividends received from French corporations are exempt up to an amount of 3,000 Fr.Frs. provided that the recipient's taxable income does not exceed 180,000 Fr.Frs.
(c) Interest in an aggregate amount of 3,000 Fr.Frs. received on bonds issued by French or foreign entities is exempt provided that the bonds are quoted on a French stock exchange and that they are not subject to an index clause.
(d) Persons owning the house in which they live are not subject to income tax with respect to the annual rental value of the house; they may, however, within certain limits, deduct interest paid on loans contracted for the construction or important repairs of the house and expenses connected with the resurfacing of stonework.
(e) Interest and dividends received under certain long-term saving schemes (minimum duration 5 years) are within certain limits exempt.
(f) Interest on the first savings bank book with the Postal Services and interest on savings accounts for housing construction and some other purposes are exempt.
(g) Any excess of purchases over sales of certain French shares during the period between June 1, 1978 and December 31, 1981 may be deducted from income provided no use is made of the deduction under (b) and the exemption under (e). The maximum deduction is 5,000 Fr.Frs. increased by 500 Fr.Frs. for each of the first two dependent children and 1,000 Fr.Frs. for each next dependent child.

## II. INDIVIDUAL INCOME TAX

### A. Residents

#### 1. Domicile and scope

Individuals — whether French nationals or foreigners — who have their domicile in France are subject to individual income tax (impôt sur le revenu) on their worldwide income. A taxpayer is deemed to have his domicile in France:
(i) if he has his home or principal place of abode in France; or
(ii) if he performs personal services in France either as an employee or independently, unless he can prove that these services are of a subordinate importance; or
(iii) if he has his center of economic interests in France.

Note, however, that tax treaties may have an important impact on a taxpayer's tax liability. Special relief provisions apply to employees who are sent abroad but who retain their domicile in France.

#### 2. Taxable base

A resident taxpayer's taxable base is composed of the following elements:

* Executive director of the International Bureau of Fiscal Documentation.

(i) net income from industrial, commercial and handicraft activities;
(ii) net real property income;
(iii) net agricultural income;
(iv) net employment income, pensions and annuities;
(v) net income from non-commercial activities;
(vi) net income received by directors of limited liability companies;
(vii) certain net capital gains;
(viii) certain net gains derived from real property.

The sum total of these net incomes is called the *gross total income (revenu global brut)*. In order to arrive at the *taxable income* a number of deductions may be taken.

One of the most important rules is that any deficit in one of the above income categories may be deducted from gross total income. If the taxable income is *negative* the loss may be carried forward and deducted from gross total income of the next five years. Note, however, that this is only a *general* rule and that there exist important exceptions which considerably limit the possibility to offset losses.

Other deductions which may be taken from gross total income include: interest on loans for the acquisition, construction and repair of the taxpayer's principal residence as well as expenses incurred to save energy, alimony, social security premiums, gifts to charities, savings used for construction of dwellings, life insurance premiums and certain investments in shares. Note that these deductions are only allowed if a number of conditions have been fulfilled and that they are generally limited in some way or other.

## 3. Rates

Individuals are generally subject to a progressive rate of income tax. The tax table is determined at the end of the tax year, i.e. the tax table on 1980 income will be fixed by the Finance Law 1981 which will be published at the end of December 1980. Thus, the most recent tax table applies to 1979 income, as follows (single persons):

| Taxable income | 1980 (on 1979 income) (%) |
|---|---|
| 0 – 8,725 Fr.Frs. | 0 |
| 8,725 – 9,125 Fr.Frs. | 5 |
| 9,125 – 10,825 Fr.Frs. | 10 |
| 10,825 – 17,125 Fr.Frs. | 15 |
| 17,125 – 22,275 Fr.Frs. | 20 |
| 22,275 – 28,000 Fr.Frs. | 25 |
| 28,000 – 33,875 Fr.Frs. | 30 |
| 33,875 – 39,075 Fr.Frs. | 35 |
| 39,075 – 65,125 Fr.Frs. | 40 |
| 65,125 – 89,575 Fr.Frs. | 45 |
| 89,575 – 105,950 Fr.Frs. | 50 |
| 105,950 – 125,050 Fr.Frs. | 55 |
| In excess of 125,050 Fr.Frs. | 60 |

The rates are applied to each successive slice of income.

Where a taxpayer is married his income and that of his spouse are added together with that of their children under 18 years of age. Relief is given by dividing the aggregate income by a coefficient (depending on marital status, number of dependents, their health situation etc.). The income tax table is then applied to the result and the income tax thus computed is subsequently multiplied by the same coeffieient. [1]

In some cases individuals are subject to a flat rate of income tax. Some of the most important cases are:

— 15 percent on capital gains derived from the sale of a substantial participation in a company (generally a shareholding exceeding 25 percent) and gains derived from major transactions (generally totaling more than 150,000 Fr.Frs. annually) connected with shares or bonds with a regularly quoted price;
— 25 percent of interest from bonds and other negotiable debt instruments (the taxpayer may opt for an exemption of income tax);
— 30 percent on gains derived from habitual stock exchange transactions (generally if borrowed money is used or share options are involved or if the total amount involved during a year exceeds 1.6 times the value of the securities owned by the taxpayer at the end of the preceding year and provided further that total sales exceed 10,000 Fr.Frs. during the year);
— 38 or 40 percent on interest from savings deposits, current accounts (40 percent on interest accrued before January 1, 1980) (the taxpayer may opt for an exemption from income tax);
— 38 or 42 percent on interest from certain treasury bonds (42 percent if the recipient is not disclosed);
— 33 1/3 percent on gains derived by persons who improve real property with a view to its sale if they sell completed dwelling houses (this privilege is limited to 400,000 Fr.Frs. per four years).

## B. Non-residents

Non-residents, i.e. persons who do not have their domicile in France, are subject to French income tax with respect to income from French sources covered by the categories of income listed above. Non-resident aliens who possess one or more residences in France are subject to tax on a minimum income of three times the annual rental value of their residence(s) in France. This provision does not apply to non-resident French citizens and citizens of countries which have concluded a tax treaty with France containing a non-discrimination clause.

The general rule is that the taxable income of non-residents is computed in the same manner as for resident taxpayers and that the same income tax rates apply. However, for a non-resident — whether a French national or an alien — a minimum rate of 25 percent is applicable unless he can show that the overall rate of French income tax on his world-wide income would be lower than 25 percent in which case the lower rate applies. If the income tax levied at 25 percent does not exceed 2,000 Fr.Frs. it will not be collected.

1. See for a detailed explanation and computation examples, SUPPLEMENTARY SERVICE TO EUROPEAN TAXATION, Section B : France.

There are a number of exceptions to the above rule of which the most significant are discussed below.

Non-resident taxpayers are subject to a graduated withholding tax with respect to their French-source employment income. Its rates on an annual basis are:

| | |
|---|---|
| up to 25,800 Fr.Frs. | nil |
| from 25,800 — 76,100 Fr.Frs. | 15 percent |
| in excess of 76,100 Fr.Frs. | 25 percent |

The rates are applied to each successive slice of income and apply to *1980* income. The taxable base is the *net* income after deduction of expenses (see box). This withholding tax is a final tax for that part of the employment income which does not exceed 76,100 Fr.Frs. provided that the recipient of the income is either a French national or a person possessing the nationality of a country with which France has concluded a tax treaty containing a non-discrimination clause. The remainder is also subject to the individual income tax but the withholding tax may be credited against the individual income tax. However, a refund is not given.

A flat-rate 33 1/3 percent withholding tax applies to gross income from non-commercial activities exercised in France or to French-source royalties connected with copyrights, patent rights and other industrial property, provided that the debtor of the income is established in France and the creditor does not have a fixed base in France. The withholding tax may be credited against the individual income tax but it is never refunded.

In a number of cases there is a withholding tax levied at a flat rate which replaces the graduated individual income tax, for instance:

- 25 percent on dividends distributed by French companies;
- 25 percent on interest from French bonds and certain other negotiable loan instruments, and at varying rates (33 1/3, 38, 40 or 42 percent) on other interest;
- 33 1/3 percent on certain taxable capital gains (for instance, French-situs real property capital gains);
- 50 percent on certain French-situs real property gains in case of speculation or building construction.

## III. CORPORATE INCOME TAX

### A. Resident corporations

#### 1. Residence and scope

Corporations resident in France are with respect to their "active" income (income from business operations) subject to corporate income tax (impôt sur les sociétés) on income earned or deemed to have been earned in France. With respect to their "passive" income (investment income such as dividends, interest and royalties), the tax is levied on world-wide income. Resident corporations are those corporations which have been incorporated in France or which have their seat (siège social) in France.

Foreign-source "active" income, i.e. income earned through a foreign-situs permanent establishment, or representative established abroad or through the completion of a cycle of commercial activity abroad is generally exempt. Under certain circumstances, subject to the approval of the tax authorities, a French corporation may consolidate its income with that of its foreign permanent establishments or even its foreign subsidiaries. French corporate income tax is then imposed on the aggregate income of the French corporation, its permanent establishments and subsidiaries and any foreign income and withholding tax may be credited against French corporate income tax.

Recent legislation introduced an anti-tax avoidance measure under which — if a number of conditions have been satisfied — a French parent corporation may receive an additional corporate income tax assessment for a proportional share of income earned by a foreign subsidiary in which it holds at least a 25 percent interest, provided that the foreign subsidiary is established in a low-tax area. In this event there is no consolidation of income, so that any foreign losses are disregarded. Foreign income or withholding taxes may be credited against French corporate income tax assessed on the foreign subsidiary's income or dividend contributions. [2]

Double tax treaties may allocate income items to France for taxation which thus become part of a corporation's taxable income even in those cases where the income would under the French national rules have been exempt. This is particularly significant for income derived through the completion of a commercial cycle abroad which would otherwise not be subject to income tax at all. Another deviation from the rule that French corporate income tax is only imposed on French-source business income is that a provisional deduction is available with respect to initial losses incurred for (i) the installation of a foreign sales office, (ii) a foreign information office or (iii) a foreign office to conduct research either through a foreign permanent establishment or, indirectly, through a foreign subsidiary. Similarly, a provisional deduction is allowed with respect to certain industrial investment in developing countries (see *reserve for investment abroad*, infra).

#### 2. Taxable base

Some significant factors which determine the computation of the taxable base for corporate income tax purposes are discussed below:

a. *Depreciation of business assets*

Depreciation may be taken on all tangible assets, fixed or movable, owned by and used in the business, which necessarily diminish in value over time and whose useful life exceeds one year. Patents and relating manufacturing rights can also be depreciated. Other intangible rights such as good will, copyrights, trademarks, secret processes, etc. and land may, however, be the object of provisions where the value of the business as a whole is

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2. See D.A. van Waardenburg, "France: Finance Law 1980", in 20 EUROPEAN TAXATION 113 (1980).

**EMPLOYMENT INCOME RELIEF**

The French "tax climate" is particularly mild for wage earners, who generally only pay income tax on 72 percent of their net salary income.

They may take the following deductions:

(a) old age pension premiums;
(b) from the remaining amount, the taxpayer may deduct the greater of either 10 percent of that amount, or a lump sum amount of 1,800 Fr.Frs. or actual expenses (hereinafter referred to as "ordinary deduction"); for 1979 income the maximum deduction is 40,000 Fr. Frs.;
(c) the balance is further reduced by an "extra deduction" of 20 percent on the first 360,000 Fr.Frs.; this deduction is reduced to 10 percent for persons who hold directly or indirectly more than a 35 percent interest in a company with respect to salaries in excess of 150,000 Fr.Frs. which they receive from that company.

For special categories of employed persons (e.g. journalists, artists) a supplementary deduction is allowed at percentages varying from 5 percent to 30 percent up to a maximum of 40,000 Fr.Frs. (1979 income) or 50,000 Fr.Frs. (1980 income). This deduction is applied after the ordinary deduction of 10 percent is made.

reduced and a substantial fall in profits is demonstrated.[3]

In principle both the straight-line and declining balance methods of depreciation are permitted. However, whereas straight-line depreciation is always applicable, the field of application of the declining balance method is narrower since it may not be used with respect to buildings (with the exception of hotel buildings and light construction whose maximum life does not exceed 15 years). Also, second-hand assets are generally excluded from declining-balance depreciation, with the exception of renovated assets, assets used for construction abroad and second-hand ships.

The rate of straight-line depreciation is computed by dividing the expenditure by the estimated number of years of its life. The rate of declining balance depreciation is computed by multiplying the rate of the straight-line depreciation by a certain coefficient prescribed by law:

- 1.5 if the life of the asset is 3 or 4 years;
- 2.0 if the life of the asset is 5 or 6 years;
- 2.5 if the life of the asset exceeds 6 years.

Deviations from the main rule:

(i) *Assets acquired between June 30, 1974 and July 1, 1975*

Reduction of the coefficients to 1, 1.5 and 2.

(ii) *Assets acquired or manufactured in 1977 (when purchased the order must have been placed before June 1, 1977)*

Increase of the coefficients to 2, 2.5 and 3.

The above increase coefficients also apply to energy-saving equipment acquired from January 1, 1977 onwards; to equipment-saving raw materials used from January 1, 1978 onwards; and to assets used in energy-saving projects from January 1, 1979 onwards.

In some cases depreciation on the basis of "unit of production" has been permitted, thus adapting depreciation to the intensity of use in case of double or triple shift work (e.g. in steel factories).

Deduction of depreciation is compulsory up to the amount of straight-line depreciation, which means that depreciation must also be taken in loss years. However, in such a case any loss corresponding to the amount of depreciation may be carried forward indefinitely to later years and is not limited to five years as would normally have been the case.

A change-over from declining-balance to straight-line depreciation is permitted when the depreciation deduction computed according to the declining balance method is less than the deduction computed by dividing the net depreciable balance by the remaining years of useful life.

b. *Accelerated depreciation*

Accelerated depreciation is only possible in a limited number of cases specifically regulated by the law. It consists mostly in an initial deduction ranging from 25 to 100 percent and straight-line depreciation with respect to the residual value (if any) of the asset. The following initial deductions are available:

(i) 25 percent for investment in certain industrial and commercial real property in certain development areas under Government approval, provided that their construction was started before December 31, 1977;
(ii) 50 percent for buildings for scientific or technical research and for certain buildings for the prevention of water or air pollution, which have been completed before January 1, 1981; also for subscription to shares of Government-approved research companies and "financial innovation" companies;
(iii) 50 percent of the cost price of assets for scientific or technical research, to be defined in a decree, provided that the investment is effected in France. Enterprises which employ more than 2,000 persons do not qualify nor do companies more than half of whose shares are directly or indirectly owned by companies whose stock is listed at the stock exchange;
(iv) 100 percent for subscription of shares in Government-approved companies for the development of agriculture, industry and commerce.

c. *Investment deduction*

The following investment deductions are available:

3. This definition appears in THE TAXATION OF COMPANIES IN EUROPE, Chapter France at 79. See generally: "France: Part II of a comparative analysis of fiscal depreciation and investment allowance facilities available to corporate entities in the Common Market", in 11 EUROPEAN TAXATION I/186 (1971).

(i) 10 percent of *additional* investment (investment in excess of preceding year's investment) made in 1979 and 1980. Qualifying assets are depreciable tangible assets utilized in France. A number of enterprises are excluded from this relief such as insurance companies, real property companies, most financial institutions and in general those enterprises the cost price of whose depreciable tangible assets qualifying for declining-balance depreciation is less than 2/3 of the cost price of total depreciable tangible assets (not including buildings).

(ii) Enterprises publishing newspapers and certain magazines which are to a large extent devoted to the dissemination of political information are granted relief for the acquisition of business assets (excluding land and participations). This measure, which has been changed numerous times, provides for 1980 that 65 percent of income from daily newspapers and 40 percent of income from other publications may be used or placed in a reserve free of income tax. Only 90 percent of the cost price of assets for daily newspapers and 55 percent of the cost price of assets for other publications may be financed through this provision.

(iii) Enterprises employing more than 100 employees must participate in a profit sharing scheme on behalf of their employees. For this purpose they must make an annual contribution to a special reserve of 50 percent of their adjusted taxable income times a coefficient which is based on the ratio between the payroll and the value added. This contribution may be deducted from the taxable income of the subsequent year and the enterprise may, in addition, place an amount equal to a certain percentage of the amount entered in the reserve for the profit sharing scheme in a tax free reserve, to be used within 12 months, for the acquisition of fixed assets.

d. *Depletion deduction*

A depletion deduction is available to companies which are engaged in the search for and exploitation of gas or oil or in the extraction of certain specified solid minerals. The amount deducted from taxable income must be reinvested within five years. For gas and oil, the deduction amounts to the lower of 23.5 percent of turnover or 50 percent of the profit resulting from this turnover. For qualifying minerals the deduction is the lower of 15 percent of turnover or 50 percent of the profits resulting from the pertinent turnover.

e. *Reserves*

(i) *Reserve for investment abroad*

Companies investing abroad through a foreign branch office or through a foreign subsidiary company may during the first five years after the investment enter certain amounts in a tax free reserve, provided Government approval has been obtained. A distinction is made between investment in *commercial* and *industrial* enterprises.

If investment takes place in a *commercial* enterprise in a Common Market country (other than France) the amounts placed in the tax free reserve may not exceed the lesser of (i) the accumulated losses of the first five years and (ii) the accumulated amount of the investment. If investment is made in a non-Common Market country, the full amount of the investment may be placed in the tax free reserve, but Government approval is generally only available if investment takes place in a developing country.

If investment takes place in an *industrial* enterprise abroad an amount not exceeding 50 percent of the investment may be placed in the tax free reserve, but generally only investment in a developing country qualifies for this privilege.

A recent law has extended the above privilege to banks and other enterprises participating in foreign commercial and industrial ventures in support of a French company investing abroad.

The amounts thus deducted from taxable income must after five years be added back to income in five equal annual installments.

(ii) *Reserve for commodity market fluctuations*

A reserve for commodity market fluctuations may be created by resident corporations whose main business is the processing of certain raw materials (including gold, silver, certain textiles and oil seeds, rubber, cocoa, etc.) to take account of world commodity market fluctuations and, for some other raw materials, French commodity market fluctuations connected with the world market.

(iii) *Reserve for price increases*

A reserve for inventory price increases may be created in any year in which, on an item by item basis, the unit price has increased by more than ten percent during a period which may not exceed two accounting years. The reserve must be added back to taxable income within a period of six years.

f. *Inventory valuation*

Inventory is valued at either cost or current sales price, whichever is less. With respect to inventory determination some form of the FIFO system (first in, first out) or an average cost method is used. LIFO (last in, first out) is generally not permitted unless it reflects actual practice of the enterprise.

g. *Deductibility of taxes paid*

Generally only income taxes are non-deductible This rule also applies to foreign income taxes pertaining to foreign exempt income. Foreign income taxes pertaining to income subject to French corporate income tax are, absent tax treaty provisions to the contrary, deductible. Examples of deductible taxes are: registration and stamp taxes, payroll taxes, business tax and excises. However, the value added tax is not normally deductible since it is not an effective burden on the company.

h. *Deductibility of dividends received (parent-subsidiary relationships)*

Dividends received are generally included in taxable income for purposes of corporate income tax grossed up by the 50 percent "avoir fiscal" (special credit) to which the recipient corporation is entitled. However, dividends received from either a resident or non-resident corporation are exempt for 95 percent of their amount (sometimes less) provided that the participation is:

- at least 10 percent of the distributing corporation's share capital (or less, if the participation percentage drops below 10 percent merely as a result of the increase of the capital of the subsidiary *and* the cost price of the participation at the moment of its acquisition was at least 2,000,000 Fr.Frs.); or
- was acquired for at least 10,000 Fr.Frs.; or
- the shares were acquired in a merger operation.

Other conditions for the deduction are: (i) the parent corporation must have acquired the shares in exchange for its contribution to the subsidiary's capital or it must be bound to hold the stock for at least two years and (ii) it must hold the shares in registered form or the shares must be deposited in an approved organization.

Dividends received from resident and non-resident subsidiaries (in case of dividends distributed by resident subsidiaries grossed up to include the 50 percent "avoir fiscal") are exempt in the hands of the qualifying parent corporations for 95 percent of their net amount. If the parent corporation proves that its expenses incurred from the participation are less than 5 percent of the amount of the dividends, the exempt proportion of 95 percent may be increased accordingly.

If a French parent corporation re-distributes to its own shareholders exempt dividends received from its foreign or domestic subsidiary, it is subject to an additional 50 percent tax [4] — the so-called "précompte" — with respect to those dividends. With respect to dividends received from a domestic subsidiary the "précompte" is completely offset by the "avoir fiscal". This is not the case, however, with dividends received from a foreign subsidiary. The "précompte" is refunded to shareholders of the French parent corporation who are resident in a country with which France has concluded a tax treaty.

i. *Deductibility of dividends distributed*

Dividends distributed by a French corporation are not normally deductible for purposes of the corporate income tax. However, in order to stimulate the French economy, such deduction is permitted to French corporations which are created or which increase their capital between January 1, 1977 and December 31, 1981. They may, during the first seven years (for shares with preferential dividend, ten years) following such creation or increase, deduct the dividends they distribute with respect to the newly issued shares, provided that the contributions were made in cash and that the shares were quoted on the stock exchange within three years. The latter condition has been waived for shares issued between June 1, 1978 and December 31, 1981. The deduction is limited to 7.5 percent of the capital contributed.

This deduction is also applicable to dividends distributed on shares at the conversion of certain loans into share capital with the provision that these loans must have been granted for a period of at least twelve months by shareholder-directors of the corporation and that after the capital increase less than 50 percent of the voting power is held by one or more corporations.

j. *Relief for small and medium-sized industrial businesses*

Small and medium-sized industrial businesses (PMI's) created between June 1, 1977 and January 1, 1981 may either (i) deduct in the year that they are created and in the four succeeding years, from their taxable income before deduction of losses carried over from preceding years, one third of this taxable income, or (ii) they may benefit from a tax holiday under which their undistributed income of the year of their creation and the next two years is exempt from corporate income tax, provided that:

(i) their turnover does not exceed 30,000,000 Fr.Frs. and their staff does not exceed 150 employees; and
(ii) the total acquisition cost of the assets which qualify for declining-balance depreciation equals at least two thirds of the total acquisition cost of all tangible depreciable assets (exclusive of buildings); and
(iii) other companies do not directly or indirectly hold more than 50 percent of the voting rights.

Where a company opts for the tax holiday it must in addition convert the exempted income into capital.

K. *Losses*

The general rule is that losses may be carried forward to be set off against the profits of the next five years. However, losses corresponding to depreciation may be carried forward indefinitely. Where a corporation has created a long-term capital gain reserve (see below under 3. Rates), this reserve may be used to offset ordinary losses irrespective of their age and long-term capital losses of the following ten years. Long-term capital losses may also be deducted from long-term capital gains of the following ten years.

## 3. Rates

The normal rate of corporate income tax is 50 percent. The balance of long-term capital gains and long-term capital losses (generally connected with business assets held for at least two years) is subject to a tax at a reduced rate of 15 percent (or 25 percent for the sale of building lots). The capital gains less the amount of tax due must be placed in a reserve; on distribution, the gains are taxed at the normal rate of corporate income tax but the tax already paid is creditable. An additional 50 percent [5] tax (précompte) is due at the distribution of income exempt from French corporate income tax (or subject to a rate less than 50 percent). This is, for instance, the case with income derived from a foreign branch office or dividends received from a subsidiary (see h. Deductibility of dividends received (parent-subsidiary relationships), above). The "précompte" is also imposed on income which has been retained for more than five years.

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4. The rate is 50 percent if related to the net dividend distributed, but it is 33 1/3 percent if related to the income *before* dividend.
5. Id.

Corporations are also subject to an annual lump sum tax of 3,000 Fr.Frs. This tax is creditable against corporate income tax payable in that tax year and the next two tax years. Newly created corporations are exempt from this tax for three years, provided that at least 50 percent of their capital was contributed in cash.

### B. Non-Resident Corporations

Non-resident corporations are subject to French corporate income tax at the rate of 50 percent with respect to income derived from business activities in France through either:
- a permanent establishment in France; or
- a permanent representative in France; or
- a "complete cycle of commercial activity" in France.

This income less the corporate income tax due is also subject to a substitute withholding tax of 25 percent, so that foreign corporations are normally subject to a rate of 62.5 percent. If it can be proved that the total income actually distributed by the foreign corporation within twelve months following the tax year is less than the French branch's net distributable income, an appropriate refund of the substitiute withholding tax is made. This will also be the case where it can be demonstrated that the foreign corporation made dividend distributions to shareholders resident or established in France. Under tax treaty provisions the substitute withholding tax is usually reduced or even waived.

A non-resident corporation receiving French-source non-business income such as rentals from French-situs real property is only subject to the standard 50 percent rate of corporate income tax. French-source dividends are only subject to a withholding tax at the rate of 25 percent, whereas interest is subject to withholding tax at varying rates (23, 33 1/3, 38, 40 or 42 percent). Royalties are subject to a 33 1/3 percent withholding tax which may be credited against the corporate income tax due. Tax treaties generally reduce these rates.

A 33 1/3 percent rate of corporate income tax is imposed on accessory income from housing construction by foreign corporations which are financial institutions or which appoint a representative in France. To be recognized as "accessory" the income must not exceed 25 percent of the foreign corporation's total income.

## IV. PAYROLL TAXES

The following payroll taxes are levied:

### A. Taxe sur les salaires

The salary tax (taxe sur les salaires) is not due where the taxpayer is subject to value added tax on at least 90 percent of his turnover.

#### 1. Taxable base

The taxable base is the goss amount of salaries and wages paid during a calendar year including payments in kind. Social security payments due by the employer are generally not included in the taxable base.

#### 2. Rates

The normal rate is 4.25 percent. This rate is increased to:
- 8.5 percent for that part of individual salary which exceeds 32,800 Fr.Frs. but does not exceed 65,600 Fr.Frs.; and
- 13.6 percent for that part of individual salary which exceeds 65,600 Fr.Frs.

### B. Taxe d'apprentissage

The purpose of the apprenticeship tax (taxe d'apprentissage) is to finance apprenticeship schemes and technical training. Partial or total exemption from this tax can be obtained if the enterprise has an internal training program or apprenticeship scheme for its minor personnel or if the enterprise voluntarily contributes to schools and organizations serving such purposes.

#### 1. Taxable base

The taxable base is generally the same as for the salary tax.

#### 2. Rates

The normal rate is 0.5 percent. In the departments of Haut-Rhin, Bas-Rhin and Moselle the rate is 0.1 percent. The tax is temporarily increased by a surtax of 0.108 percent of 1979 payroll.

### C. Participation des employeurs au financement de la formation professionnelle continue

Every employer domiciled or established in France employing at least 10 employees is required to invest annually a certain amount in training programs for his personnel or applicants for work. If he does not contribute to such training programs he must pay an equal amount to the Treasury.

#### 1. Taxable base

The taxable base is generally the same as for the salary tax. Enterprises which in 1979 or in 1980 become liable to this tax for the first time receive a reduction of the tax in that their taxable base is reduced: by 360,000 Fr.Frs. for the first year, by 240,000 Fr.Frs. for the second year and by 120,000 Fr.Frs. for the third year.

#### 2. Rate

The rate is 1.1 percent.

### D. Participation obligatoire des employeurs à l'effort de construction

Every employer domiciled or established in France employing at least 10 employees is obliged to invest a certain amount in the construction of dwelling houses.

This may be effected in the form of granting loans to employees to assist them to finance their housing.

### 1. Taxable base

The taxable base is generally the same as for the salary tax, except that salaries paid in the *preceding* calendar year are taken. Enterprises which in 1979 or 1980 become liable to this tax for the first time receive a reduction of the tax in that their taxable base is reduced by 360,000 Fr.Frs., 240,000 Fr.Frs. and 120,000 Fr.Frs. respectively in the first, second and third years of their existence.

### 2. Rate

The rate is 0.9 percent, but upon failure to meet its obligation the enterprise must pay a penalty of 2 percent of the taxable base to the Treasury.

## E. Social security contributions

The total of social security contributions an employer has to pay for each employee can be broken down as follows:

| | |
|---|---|
| For illness | 8.95% on $C^1$ |
| | + 4.5 % on total salary |
| For old age | 8.2 % on $C^1$ |
| For child benefits | 9 % on $C^1$ |
| For housing aid | 0.1 % on $C^1$ |
| For unemployment | 2.76% on $C^2$ |
| For salary guarantee | 0.25% on $C^2$ |
| For supplementary pensions | |
| executives | 2.64% on $C^1$ |
| | + 6.18% on $C^2 - C^1$ |
| non-executives | 2.64% on $C^2 - C^1$ |

Where C stands for the maximum amount per employee subject to social security contribution:

| | | |
|---|---|---|
| $C^1$ | = | 60,120 Fr.Frs. |
| $C^2$ | = | 240,480 Fr.Frs. |
| $C^2 - C^1$ | = | 180,360 Fr.Frs. |

Note that in various branches of business different social security contributions apply, in particular with respect to accident insurance. Special levies are imposed on employers in the Paris area to finance transportation (2 percent on $C^1$ plus 23 Fr.Frs. per employee).

# V. BUSINESS TAX

### 1. Scope

The business tax (taxe professionnelle) is imposed on all taxpayers carrying on commercial, industrial or certain types of professional activities.

### 2. Taxable base

The taxable base consists of two elements:
(i) the annual rental value of buildings and equipment used for the taxable activities; and
(ii) one fifth (sometimes one tenth) of payroll.

It is the Government's intention to replace this twofold taxable base by a single one: the value added by the enterprise.

### 3. Rate

Since the business tax is a local tax, rates differ from municipality to municipality.

# VI. VALUE ADDED TAX

### 1. Scope

The value added tax (taxe sur la valeur ajoutée (VAT)) is a non-cumulative tax, imposed at each stage of the production and distribution cycle. An entrepreneur may credit the VAT invoiced to him (input tax) against the VAT which is due on his sales (output tax). The tax is levied on the sale of goods, the rendering of services and the importation of goods.

### 2. Taxable base

The taxable base is the price charged or, in case of importation, the customs value, excluding the VAT.

### 3. Rates

| | | |
|---|---|---|
| Standard rate | : | 17.6 percent |
| Reduced rate for essentials | : | 7 percent |
| Luxury rate for certain sales and services deemed to have luxury character | : | $33^1/_3$ percent |

Reduced rates may also apply in special cases, for instance, 2.1 percent for daily newspapers.

# VII. REGISTRATION TAXES

Some of the most significant registration taxes are:

## A. Registration tax at the sale of real property

The sale of real property is normally subject to registration tax increased by a number of local surtaxes. However, the sale of new buildings is subject to VAT and exempt from registration tax.

### 1. Taxable base

The taxable base is generally the sales price of the sales value of the property whichever is higher.

### 2. Rate

The aggregate rate of the registration taxes varies between 16.6 and 18.2 percent depending on the region where the property is situated. A reduced rate varying between 5.4 and 7 percent applies to sales of dwelling houses.

## B. Creation of a company

At the creation of a company a fixed registration tax of

75 Fr.Frs. is due in addition to the registration tax which is due on the value of the contribution.

### 1. Taxable base

The amount of cash contributed or, in case of contribution in kind, the fair market value of the contribution.

### 2. Rates

Cash contributions are subject to a 1 percent rate whereas contributions in kind (real property, shares representing real property, good will, clientele, leasehold rights (or options thereon) and shares of "transparent" real estate companies) if made by a person not subject to corporate income tax are subject to 11.4 percent registration tax. However, if such contributions are made by an entity subject to corporate income tax the rate will also be 1 percent.

## C. Succession and gift tax

When an individual domiciled in France (see for the concept of "domicile" the discussion of the individual income tax, supra) dies, his total estate wherever situated is subject to succession tax. The tax is imposed on the share each inheritor receives. Similarly, where a person domiciled in France donates property wherever situated, such donation is subject to gift tax. Persons domiciled abroad are only subject to French succession or gift duty with respect to French-situs property. Donations for which there is no need of registration (hand to hand gifts of cash) are not subject to gift tax but will become taxable at a later registration or eventually on the death of the donor.

### 1. Taxable base

Generally the fair market value of any property except cash. An exemption of 175,000 Fr.Frs. applies between spouses and between persons in the direct line of consanguinity.

### 2. Rates

**Table 1**
**Transfers in the direct line of consanguinity except inter vivos gifts to descendants (donations-partages)**

| *Value received (Fr.Frs.)* | *Rate of tax (%)* |
|---|---|
| 0 - 50,000 | 5 |
| 50,000 - 75,000 | 10 |
| 75,000 - 100,000 | 15 |
| in excess of 100,000 | 20 |

**Table II**
**Inter vivos gifts to descendants (donations-partages) and transfers between spouses**

| *Value received (Fr.Frs.)* | *Rate of tax (%)* |
|---|---|
| 0 - 50,000 | 5 |
| 50,000 - 100,000 | 10 |
| 100,000 - 200,000 | 15 |
| in excess of 200,000 | 20 |

**Table III**
**Other transfers**

| *Degree of consanguinity Transfer between:* | *Rate of tax (%)* |
|---|---|
| Brothers and sisters | |
| 0 - 150,000 Fr.Frs. | 35 |
| in excess of 150,000 Fr.Frs. | 45 |
| Persons up to and including the fourth degree | 55 |
| Others | 60 |

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* For abbreviations, see the list at the end of this Selected Bibliography.

## LIST OF ABBREVIATIONS

| | |
|---|---|
| A | Archiv für Abgabenrecht – monthly – Genossenschafts-Buchdruckerei, Habsburgerstrasse 19, 3000 Bern 16, Switzerland. |
| AG | Aktiengesellschaft – monthly – Verlag Dr. Otto Schmidt KG., 5 Köln 51, Ulmenallee 96-98, West-Germany. |
| AWD | Aussenwirtschaftsdienst des Betriebs-Beraters (changed to: Recht der Internationales Wirtschaft – RIW) – monthly – Verlagsgesellschaft Recht und Wirtschaft mbH., 6900 Heidelberg 1, Häusserstrasse 14, Postfach 105960, West Germany. |
| B | Der Betrieb – weekly – Verlag Handelsblatt GmbH., Düsseldorf 1, Kreuzstrasse 21, Postfach 1102, West Germany. |
| BDPID | Bulletin de Documentation Pratique des Impôts Directs et des Droit d'Enregistrement – monthly – Editions Francis Lefebvre, 44 rue de Villiers, 92300 Levallois, France. |
| BIFD | Bulletin for International Fiscal Documentation – monthly – International Bureau of Fiscal Documentation, P.O. Box 20237, 1000 HE Amsterdam, the Netherlands. |
| BMIS | Bulletin Mensuel d'Information des Sociétés – monthly – Dictionnaires Joly, 26 Cours Albert 1-er, 75008 Paris, France. |
| CFE | Fiscalité Européenne – Revue – quarterly – Les Cahiers Fiscaux Européens, 51 Avenue Victoria, 06000 Nice, France. |
| ET | European Taxation – monthly – International Bureau of Fiscal Documentation, P.O. Box 20237, 1000 HE Amsterdam, the Netherlands. |
| EuMTR | European and Middle East Tax Report – Fortnightly – Institute for International Research, Ltd., 70 Warren Street, London W1P 5PA, United Kingdom. |
| INTR | International Tax Report – fortnightly – Institute for International Research, Ltd., 70 Warren Street, London W1P 5PA, United Kingdom |
| IWB | Internationale Wirtschafts-Briefe – fortnightly – Verlag Neue Wirtschafts-Briefe GmbH, Herne (Westfalen), Postfach 1620, West Germany. |
| JCPCI | La Semaine Juridique – Juris Classeur Périodique – Commerce et Industrie – weekly. Editions Techniques, 123, rue d'Alésia, 75014 Paris, France. |
| RF | La Revue Fiduciaire – monthly – Service Abonnement Revue Fidiciaire, 54 rue de Chabrol, 75480 Paris, France. |

# Legislation in Latin American Countries and Criteria Applicable for the Taxation of Income

by Edison Gnazzo* (Uruguay) and Enrique Piedrabuena** (Chile)


**(Paper to be delivered at the 34th Congress of the International Fiscal Association (IFA), Paris, September 14 to 19, 1980.)**

**CONTENTS**



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# Foreword

*The report we here introduce has the great interest of offering a complete and up to date view of the legislative situation in the 18 Latin American countries. It is fundamental for considering Subject II of the 34th IFA Congress, to which it is closely related. In the Scientific Committee, and taking into account the interest that a single report about the Latin American position implied, I proposed to assign it an official character and subsequently to include it in the CAHIERS. Because of regulations, especially with regard to the national character the reports submitted to the IFA Congress must have and the concern it would not follow the Instructions, it was decided to publish it in the BULLETIN FOR INTERNATIONAL FISCAL DOCUMENTATION, accepting Prof. J. van Hoorn's kind proposal.*

*The report shows the significant heterogeneity of Latin American domestic law and the resulting differences with (i) the continental doctrine, (ii) the solutions so radically held in the Model Treaties and — even more important — (iii) the treaties signed to date with the developed countries which do not follow these positions.*

*The doctrine, through several meetings of the Latin American Tax Law Institute which took place from 1956 (Montevideo) up to 1975 (Caracas), was to diminish and adjust the traditional concept of the source, as an exclusive criterion of taxing power. The conclusion reached in the last meeting constitutes the most authoritative expression of this Doctrine. It notes the source principle, but as a priority criterion and not as an exclusive one; it settles rules for the location of the income; it admits that taxation must be imposed on the basis of the net income and that tax treatment of linked enterprises must follow the general rules applied to independent corporations.* [1]

*The Model Tax Conventions drafted in Latin America, carefully analyzed in these last years at the international, non-European level,* [2] *establish the traditional concept of the source as an exclusive criterion of taxation, making them (the Model Treaties) inapplicable in practice, even as a basis or starting point in the negotiation of the few treaties signed to date. The most eloquent example of a rejection of the above Model Treaties is shown by the treaty signed by Ecuador and Germany on July 22, 1977 — not yet ratified — which follows the OECD Model, leaving aside the Andean Pact Model, which was officially passed by Ecuador in 1971, effective from January 1, 1979.*

*The other treaties follow the same trend, accepting the concept of permanent establishment, so resisted in Latin America, co-participation in the taxation of dividends, interest and royalties, and, what is worst for the source theory, accepting a limitation in the rates which is not applicable for the co-contracting countries.*

*The domestic legislation, as stated above and also clearly shown in the report, has a great heterogeneity and differences with the mentioned precepts. Some points must be noted, for example, the fact that eight countries adopted world income as a taxation criterion, which means a broadening of the source concept which approaches the domicile concept. Colombia, Chile, Honduras, Mexico and Peru adopted it, either for corporations or for individuals; Brazil, El Salvador and Uruguay, when individual income tax was the rule in that country, only applied the concept for this last income tax; Mexico, wholly leaving aside the source principle, also adopts the nationality criterion. From another point of view, Uruguay, in 1974, largely abandoned the source principle, as dividends and interest earned in the country and paid to persons domiciled outside the country are not taxed and royalties are*

1. The text of this conclusion, substantially in agreement with that of the 29th IFA Congress which took place later on at London, is published in English, in *30 Bulletin for International Fiscal Documentation* (1976), p. 16, and in Spanish in the official publication of the Meeting (Caracas, 1976, p. 15) and in *Revista Tributaria* (Montevideo, T.II, p. 36).
2. The subject was thoroughly discussed at the XIX Technical Conference of CIAT at Curaçao (Netherlands Antilles) in September 1977. The reports submitted to the meeting may be read in *Documents and Reports* (Costa Rica 1977). The reports we submitted, "Criteria for the allocation of the power of taxation among the different tax jurisdictions according to the type of income, assets, and taxable goods (OECD, UN Experts Group, Andean Pact and LAFTA solutions)" and "Current Status of Studies and Work on Tax Treaties", were reproduced in *32 Bulletin for International Fiscal Documentation* (1978), p. 12 and 453 and in *Estudios de Derecho Tributario Internacional*, Montevideo, 1978, p. 175 and 193.
The Andean Pact Model was especially studied in the Seminar held at the IFA Congress in Mexico in 1974, under Prof. Stanley Surrey's direction. The reports submitted were published by the International Bureau of Fiscal Documentation, in a volume entitled *Fiscal Harmonization in the Andean Countries* (Amsterdam, 1975). Our report is reproduced in Spanish: "Régimen Impositivo de las Rentas derivadas de inversiones de capital en el Modelo de Tratado del Pacto Andino", in *Rev. Derecho Fiscal* (B. Aires), t.XXIV, p. 818; in *Rev. Tributaria* (Montevideo), T.I. p. 19; and in *Estudios . . .*, op. cit. p. 117; and under the title "The treatment of investment income under the Andean Pact Model Convention. The Andean view", in *29 Bulletin for International Fiscal Documentation* (1975) T. XXIX, p. 91.
The Model of the "Basin of the River Plate" (formed by Argentina, Bolivia, Brazil, Paraguay and Uruguay) was passed at the Foreign Affairs Minister's level in December 1978 and published in *Rev. Tributaria* (Montevideo) T.V., p. 513, with the notes of a member of the working committee, D. Dentone.

*partially taxed. Nine countries, Uruguay included, in opposition to the source principle, consider that know-how (technical assistance) received from outside is taxable for mere fiscal reasons. Thus, they follow the heterodox criterion of the "paying source" which assimilates the source to the place where the payment is made, as established in LAFTA meetings, as a result of a Brazilian suggestion but, according to the report, also followed by Mexico. In conclusion, some countries, like Chile and Ecuador, have to an extent accepted the concept of permanent establishment.*

*This panorama allows one to declare that the source principle — sustained by Latin America at the international level as an exclusive tax criterion since the meeting of the Fiscal Committee of the League of Nations at Mexico in 1943, and emphatically ratified in the Models of the Andean Pact in 1971, in the "Criteria" passed by LAFTA in 1977 and lately in the Model of the "Basin of the River Plate" in 1978 — is in crisis.*

*It has been lessened and adjusted by the most authoritative continental doctrine, rejected in the Treaties approved — even by countries of the Andean Pact — with the developed countries and broken by domestic legislation which presents heterogeneous solutions without other fundamentals in view than fiscal interests, leading to the conclusion that, at present, there is no Latin American position, unless at the level of the laws in force. Thus, a question is raised about the new treaties in which the developed countries seem to be so interested.*

**Ramón Valdés Costa**

## INTRODUCTION

*Through the analysis of legislation in 18 countries, the present document attempts to summarize the current Latin American tax situation concerning the criteria of taxation applicable in each region.*

*For a better presentation of the study, it has been structured in the following way:*

*A. Summary of the legislation in the countries included in the contents, giving details in each case:*
   *I. Structure of the income tax.*
   *II. Binding criteria applied, i.e. the elements or characteristics that the tax regulations take into consideration to define its scope of application.*
   *III. General considerations on the admission of deductible expenses to determine the taxable income of taxpayers, with special emphasis on the expenses incurred abroad and services rendered abroad.*

*B. General conclusions on each of the points mentioned in A. above (with additional information in Tables 1, 2, 3 and 4).*

*C. Conclusions regarding the treatment of income derived from international activities (transport, insurance, news, films). See Tables 5 and 6.*

*In each case, information has been obtained from the legislation in force as of November 30, 1979.*

## A. SUMMARY OF INCOME TAX LEGISLATION IN 18 LATIN AMERICAN COUNTRIES

### ARGENTINA

#### I. TAX STRUCTURE

The "Impuesto a las ganancias" is imposed on the total annual income of individuals and companies. Companies are taxed at a fixed rate of 33 percent and individuals on a progressive scale between 7 and 45 percent. Permanent establishments, whether commercial, industrial or of any other type, belonging to companies or entities constituted abroad, or to individuals resident abroad, pay 45 percent. When dividends are remitted to beneficiaries abroad, a final tax of 17.5 percent is paid. This tax is also applicable to beneficiaries resident in the country unless they disclose their identity, in which case they must then compute the dividends in their personal return; otherwise a final withholding of 17.5 percent is applied.

#### II. BINDING CRITERIA

The tax is applied to earnings of Argentinian source.

The law determines that in general "income of Argentinian source is that derived from assets located, placed or utilized economically in the Republic, from carrying out in the territory any act or activity susceptible to profitability, or acts performed within the country, not taking into consideration nationality, domicile or residence of the owner or of the parties intervening in the operations, nor of the place in which the contract is agreed upon". Notwithstanding the aforementioned, the legislation taxes "income derived from activities carried out occasionally abroad by persons resident in the country", adding that these persons "shall compute as payment, in advance of the tax, the amounts effectively paid in the place where such activities are carried out. This credit can only be computed up to the amount of the tax on the income incorporated from abroad."

At the same time the law qualifies as income of Argentinian source the profit derived from guaranteed loans "in rem" when the respective assets are located in the Argentine Republic. However, interest derived from debentures is fully considered of Argentinian source when the issuing entity has been incorporated or located in the Argentine Republic.

In addition, the compensation paid to members of company boards and other entities incorporated in Argentina, even for work performed abroad, is considered of Argentinian source, as well as the fees and other remuneration derived from technical, financial or other assistance provided from abroad.

In connection with the exemptions granted by the Argentinian legislation and the treatment of these exemptions in the legislation of other countries (mainly in relation to the "tax sparing" clause), the law establishes that these exemptions will not be effective as long as they are not recognized in the country of origin of the investment to the extent that a transfer of revenue to foreign treasuries could arise from these exemptions. This provision is not applicable in cases which are expressly governed by tax treaties. In this respect, it is convenient to point out that the network of tax treaties to which Argentina is a signatory has been extended since 1976, the following treaties existing to avoid double taxation on income and capital:

- Bolivia, approved in 1976, to be ratified shortly;
- Chile, signed in 1976, not yet ratified;
- Germany, Federal Republic, signed in 1978, already ratified, only the exchange of ratification documents is still missing;
- France, agreed on in 1979, not yet ratified;
- Sweden, agreed on in 1962, not yet ratified;
- Austria, Belgium, Canada, Italy, Russia, Spain, the United States, Finland and the Netherlands, negotiations are in course.

The regulations establish that expenses incurred abroad are deemed to have originated in profits of foreign source, but the Tax Administration is empowered to authorize the deduction if the taxpayer proves that these expenses have been made in order to obtain profits of Argentinian source.

In the case of permanent establishments of foreign entities, the local accounting must be kept separately from head office accounting. In addition the law states that the contract agreed upon between a foreign-owned local entity and entities domiciled abroad, controlling directly or indirectly the local company, will be considered as a transaction made between independent parties, when the economic considerations and conditions are in accordance with the normal practices of the market between independent entities (arm's length principle) with the following limitations:

- Loans: Provided that the transaction has not been rejected by the Central Bank, which must occur within 30 days of the communication of the transaction.
- Contracts governed by the law of technological transfer: In accordance with Law 21,167 of 1977, in contracts between a foreign-owned local entity and the foreign company that controls it directly or indirectly, royalty payments will not be admitted for the utilization of trademarks, and the payments made by the local entity cannot be expressed in lump sums; in addition, the payments will be deemed to accrue in annual periods coinciding with the end of the financial year and will have to be paid after such date.

In addition it is established that the compensation or salary paid to the members of the Board of Directors of a company or other entities abroad, as well as fees and other compensations paid for technical assistance from abroad, will be deductible provided these compensations do not exceed the following limits:

- 3 percent of the sales or receipts, established as the payment in the contract;
- 5 percent of the amount of the investment actually made on the basis of the technical assistance.

On the other hand, the deduction on compensation paid to a member of the Board of Directors, or to other entities incorporated or domiciled abroad who rendered the services abroad, cannot exceed the following limits:

- up to 2.5 percent of the trading profits of the entity provided that such profits have been distributed as a dividend;
- up to 2.5 percent of the trading profits of the entity when dividends are not distributed. This percentage will be increased in proportion to any distribution made, up to a limit of 12.5 percent.

The Tax Administration is empowered to determine other percentages in special cases.

# BOLIVIA

## I. TAX STRUCTURE

The income tax is applied on the basis of progressive rates (between 4 and 48 percent) in the case of individuals and a flat rate of 30 percent in the case of companies; the tax rate can be reduced by 30, 40 and 50 percent on profits that the companies reinvest in certain priority activities established by the law.

Companies have the obligation to withhold in the case of payments to beneficiaries domiciled abroad:

a) 30 percent as the only and final tax on the gross income in the case of remittance of profits, dividends of nominative shares, interest on loans, and from other securities;

b) in the case of individuals, the withholding is made in accordance with the progressive scale rates as the only and final tax.
In the special case of rents and other income from movables and in the case of professional fees, the withholding is made on 85 percent of the amount paid.

## II. BINDING CRITERIA

The tax is applied to Bolivian-source earnings obtained by the taxpayers, independently of the place of domicile or incorporation. In addition, and as an extension of the source principle, the following profits are considered of Bolivian source:

- interest on loans utilized in the country, granted by creditors from abroad to persons or entities domiciled in the country;
- interest on loans guaranteed by assets placed or registered in Bolivia;

- compensation received by members of the Board of Directors performing activities abroad in relation to enterprises domiciled in Bolivia;
- fees or compensation received or accrued for technical assistance or any other similar assistance rendered from abroad when the assistance relates to assets situated in Bolivia or profits from Bolivian source;
- interest on bonds or debentures when the issuing entity is domiciled in the country.

Profits derived from exports are fully considered as Bolivian-source income whilst profits from imports are considered to be foreign-source income.

The law establishes special rules for rectifying the value of exports or imports when a substantial difference with the market value is evident. In such a case an economic tie is deemed to exist between buyer and seller or vice versa.

As regards permanent establishments of foreign entities, the Internal Revenue Service is empowered to determine the net profit of these on the basis of separate accounting.

### III. DEDUCTIBLE EXPENSES

As a general principle, the law establishes that expenses incurred abroad are for the production of income of foreign source, unless it is proved that these expenses are related to the production of Bolivian income. In the case of royalties, whatever the name given by the parties, including technical assistance, as well as in the case of fees and other compensation for advice, management or services rendered in the country or abroad, the deduction of the expense is authorized.

## BRAZIL

### I. TAX STRUCTURE

Individuals are subject to tax based on progressive rates applicable to the total income. Legal entities are subject to a flat rate of 35 percent on the effective income. An additional tax rate of 5 percent is also applied during the fiscal years 1979-1981 on profits exceeding 30 million cruzeiros a year. However, there are lower rates for public utility companies (6 percent and 17 percent), for agricultural enterprises (6 percent), and others. On the other hand, there is a notional income system ("lucro presumido") applicable to small and medium size enterprises.

Taxation of dividends and profits distributed by companies domiciled or incorporated in Brazil is, briefly, as follows:

*Dividends and profits of corporations distributed to individuals domiciled in the country.*

Bearer shares without identification of the recipient; final withholding (25 percent: SACC — closed corporation; 15 percent: SACA — open corporation).

Nominative shares and bearer shares when the shareholder is disclosed; the beneficiary can opt between no withholding and incorporate the dividend in his personal tax return or he can have tax withheld (25 percent SACC and 15 percent SACA) and then include the dividends in his personal tax return, either taking the withholding as a credit or not including such dividends in which case the withholding becomes final.

*Dividends and profits remitted to beneficiaries domiciled abroad.*

A final withholding of 25 percent which may be reduced to 15 percent if the beneficiaries reinvest the profits in Brazil in industrial equipment of the enterprise. In addition a final withholding of 12 percent is applied on the profits and dividends remitted abroad if the average of remittances over three years exceeds 12 percent of capital and reserves invested in Brazil.[1]

### II. BINDING CRITERIA

In the case of individuals resident or domiciled in the country, the tax is applied on world-wide income, with a credit for the income tax paid abroad, subject to reciprocity. Legal entities and individuals not resident in the country are subject to tax only on Brazilian-source income, but the distribution is subject to the tax on dividends.

### III. DEDUCTIBLE EXPENSES

In general only costs and expenses incurred in the country can be deducted. Depreciation of fixed assets is only admitted in relation to assets located in the country; as regards provisions, only those related to activities located in Brazil can be constituted.

In connection with the payment made abroad of royalties, trademark licenses, and fees for technical assistance, it must be pointed out that the technological transfer regime has been regulated by Law No. 15 of September 11, 1975, which establishes the obligation to register all contracts of this nature with the National Institute of Industrial Property (Instituto Nacional de la Propiedad Industrial), as a basic requirement for fiscal purposes. Following this line, the payment of royalties, trademark licenses or fees for technical assistance can be accepted as a deductible expense if the following conditions and limits are fulfilled:

- there is sufficient proof of the respective expenses;
- the deductions are made during the first five years of operations of the company or when the introduction of a special production process occurs;
- registration of the contract with the INPI;
- these expenses cannot exceed 5 percent of the gross[2] income of the manufactured products or of the proceeds of the products sold;
- the expenses cannot exceed the percentage coefficients given by the Finance Ministry in relation to the respective type of product.

Payments are subject to a final withholding of 25 percent on the gross amount paid. It must be added that royalties and technical assistance payments made by a subsidiary or a branch to its home office are not deductible. However, the treaties to avoid double taxation to which Brazil is a signatory establish a maximum withholding rate of 15 and 10 percent in certain cases, while on the other hand the country of residence of the recipient establishes a matching credit between 20 and 25 percent.

## CHILE

### I. TAX STRUCTURE

The income tax is applied on a schedular basis and there is also a surtax. The structure of the system is as follows:

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1. According to a recent Law, No. 1725, of December 7, 1979, the reduction of tax in the case of interest, commission, expenses and discounts remitted abroad is now 95 percent of the 25 percent tax rate. This change reduces the effective rate of 12.5 percent at present (50 percent of 25 percent) to 1.25 percent (5 percent of 25 percent).

2. In accordance with a recent Decree-Law, No. 1730 of December 14, 1979, this percentage will be applied in the future on the net proceeds.

**Schedular taxes**

*First category:* It comprises income from capital and from mercantile, manufacturing, mining and other enterprises. There is a normal general tax rate of 10 percent, whilst corporations and joint stock companies incorporated in the country pay in addition a tax rate of 40 percent. Lottery prizes are only subject to a tax of 15 percent.

*Second category:* It comprises all compensation for personal services at progressive rates between 3.5 and 60 percent. The scale brackets are expressed in monthly tax units (which are readjusted periodically). In the case of compensation of members of the Board of Directors and university professionals, the tax is 7 percent. Income obtained by non-resident foreign individuals is exempt from this tax but an additional tax is applied instead.

*Additional tax:* A 40 percent additional tax is applied on Chilean-source income received or accrued in favour of individuals, whether nationals or foreigners, without residence or domicile in the country and by legal entities incorporated abroad with a permanent establishment in the country.

If certain royalties and technical assistance are considered unproductive or not necessary for the economic development of the country, the President of the Republic, based on a report of the "Corporación de Fomento de la Producción" and of the "Comité Ejecutivo del Banco Central de Chile", is empowered to increase the rate from 40 percent up to 80 percent.

The amounts remitted abroad to foreign producers or distributors in respect of film and television material will be subject to this tax at the rate of 20 percent. Compensation for personal services received by foreign individuals connected with scientific, technical, cultural and sport activities, when the service is carried out in Chile, will also be taxed at the rate of 20 percent.

Payments made by national airline companies to persons not domiciled or resident in Chile are exempt if they are made for technical assistance, services, interest or any other reason related to the normal activities of the company and if certain conditions are fulfilled.

*Surtax:* This tax is applicable to individuals resident or domiciled in Chile according to a progressive scale of rates between 3.5 and 60 percent of the net income determined on the basis of annual tax units (readjusted periodically). The gross income is arrived at by adding the taxable income of the different categories; from this income can be deducted the schedular taxes and 40 percent of the amounts distributed by corporations and joint stock companies, as well as 10 percent of one annual tax unit.

As a consequence, dividends and profits of corporations are distributed to nationals or foreign beneficiaries without any withholding. When the recipients are domiciled in the country, they must include the dividends in the surtax return, but they have a right to credit against the tax 40 percent of the dividends incorporated in the income.

It is important to point out that first category tax is fully subject to an annual monetary correction through the adjustment of the assets, liabilities and capital. Income and monthly expenses of professionals and independent workers who are subject to the second category tax are also adjustable.

## II. BINDING CRITERIA

As a general principle, all persons domiciled or resident in Chile pay income tax on a world-wide basis whether the source of income is located within the country or abroad, but persons not resident in Chile are subject only to tax on Chilean-source income. However, the foreigner who becomes domiciled or resident in the country for the first time will be subject to tax on Chilean-source income only for the first three years of permanency in the country. This period can be extended in special cases.

Income is considered to be of Chilean source if derived from assets located in the country or from activities performed in Chile wherever the domicile or residence of the taxpayer may be. Royalties, payments for the utilization of trademarks and other similar compensation derived from the exploitation in Chile of industrial or intellectual property are also considered to be Chilean-source income. The shares of a company incorporated in Chile are deemed to be located in Chile. In the case of loans, the source of the interest is deemed to be located in the domicile of the debtor.

When foreign-source income has to be computed, only net profits will be subject, excluding those that are not available for reasons of force majeure or act of God or by legal provisions of the country of origin.

The Chilean-source income of agencies, branches or other forms of permanent establishments of foreign enterprises doing business in Chile will be determined on the basis of the actual results obtained in the country. When such results cannot be determined from the accounting records, the Regional Tax Bureau is empowered to determine the taxable income on the basis of applying to the gross receipts of the agency the proportion between the net world income and the gross world income of the head office. The net income may also be determined by applying to the total assets of the agency the proportion existing between the world net income and the total assets of the head office.

## III. DEDUCTIBLE EXPENSES

The following rules are applied:

(a) Compensation for personal services rendered abroad is accepted as expenses provided that it is supported with sufficient documentation and when, in the judgement of the Regional Tax Bureau, its amount and nature are necessary and convenient for producting the income in Chile.

(b) Remittance abroad of royalties and technical assistance are deductible but the corresponding additional tax must have been paid.

It is important to point out, finally, that the President of the Republic is empowered to enact legislation according to international agreements and international provisions in order to avoid international double taxation or to diminish its implications,

# COLOMBIA

## I. TAX STRUCTURE

The "Impuesto sobre la Renta y Complementarios" covers the following taxes:

- Income tax on individuals, death duties and corporate tax;
- Supplementary tax on occasional gains of individuals;
- Wealth tax on individuals;
- Tax on transfers abroad of income, applicable to individuals and legal entities.

The income tax on individuals is applied on the basis of progressive rates between 10 and 56 percent. A 40 percent tax rate is applied on Colombian-source income obtained by foreign individuals without residence in the country and who are not obliged to appoint a representative in Colombia.

The tax rate applicable to corporations and companies in general is 40 percent. Foreign corporations also pay this 40 percent on taxable income. Limited liability companies and the like pay a tax rate of 20 percent.

Dividends and profits distributed to individual beneficiaries domiciled in the country are subject to a withholding on account of the final personal income tax applicable. It must be added that individuals whose wealth does not exceed 4 million pesos (approximately US$ 95,000) have the right to discount against the tax a special credit of 20 percent of the first 10,000 pesos paid as dividends. The withholding on account of the general tax is 5 percent in the case of interest paid by corporations.

The income and wealth tax rates are readjusted annually.

Occasional gains are taxed at half the rate applicable to ordinary income and if the tax so calculated is lower than 10 percent, tax will be assessed at the rate of 10 percent.

On dividends and profit transfers to home offices abroad two taxes are applied: the normal income tax and the supplementary tax on remittances, both being provisional and susceptible to reassessment. The regime is as follows:

### 1. Income tax

— The tax rate on dividends received by companies and other foreign entities is 20 percent. However, when the country under which legislation the foreign company was incorporated taxes dividends at a rate lower than 30 percent and when more than 25 percent of the total stock of the company receiving the dividends is owned by individuals resident in Colombia, whether nationals or foreigners, the applicable tax rate is 40 percent.

— Tax rate applicable to other profits, 40 percent.

### 2. Supplementary tax on remittances abroad

— Taxes applicable on the nominal amount of the remittance:
- general rate, 12 percent;
- special rate, 20 percent on the profits obtained by companies and other foreign legal entities without a permanent establishment in Colombia.

Exemption: Dividends and interest on short term loans for imports or exports of merchandise, capital assets or raw materials, and other loans registered with the exchange authorities are exempted from this tax.

— Remittances for the payment of technical assistance rendered abroad are only subject to the supplementary tax on remittances if the following conditions apply:
- that the beneficiary of the payment is not resident or domiciled in the country, and that he is not obliged to appoint a representative in Colombia;
- that the technical assistance services are not available in the country;
- that the technical assistance services are rendered only at the preoperating stage of a project.

The General Directorate of National Taxes (Dirección General de Impuesto Nacionales), with the prior authorization of the Royalty Committee referred to in Article 6 of Decree-Law 688 of 1967, will determine in each case the technical assistance services that are not available in the country.

## II. BINDING CRITERIA

Individuals resident in the country, whether nationals or foreigners, are subject to tax on their ordinary income and on occasional gains on a world-wide basis, but in the case of the wealth tax only on the wealth located within the country.

Foreign individuals resident in Colombia are only subject to tax on foreign-source income after four years of residence in the country. Individuals, whether nationals or foreigners, without residence in the country are only subject to tax on income and occasional gains of Colombian source and only on wealth located within the country.

Companies incorporated in Colombia are taxed on a world-wide basis whilst companies incorporated abroad are taxed only on Colombian-source income.

Income deemed to be Columbian-source is, inter alia:
— interest produced by local loans or economically connected with the country (interest on temporary loans for the import of merchandise and bank overdrafts is exempted);
— profits from the rendering of technical assistance services, whether rendered abroad or in the country;
— dividends and participations derived from Colombian companies domiciled in the country;
— dividends and participations received by Colombian residents, derived from companies or foreign legal entities which have business or investment in Colombia, directly or indirectly.

The Colombian taxpayer who receives foreign-source income and who is subject to income tax in the country of origin of the income has a right to credit against the Colombian tax the tax paid abroad on such profit, up to the limit of the Colombian tax applicable.

## III. DEDUCTIBLE EXPENSES

Expenses incurred abroad are deductible as long as they are related to the production of Colombian-source income, provided that the taxpayer can support with documentary evidence the expenses and the withholding of taxes in Colombia when applicable. The deduction of expenses incurred abroad for the production of income of Colombian source cannot exceed, in general, ten percent of the net income with the sole exception of expenses subject to withholding and other cases expressly determined by the law.

Payments made by corporations to individuals economically connected to them will be considered to be a distribution of profits except in the case of salaries, as well as rents and interest within certain limits.

# COSTA RICA

## I. TAX STRUCTURE

Tax is applied on the total income on the basis of progressive rates for both individuals (between 5 and 50 percent) and legal entities (between 5 and 45 percent).

Distribution of dividends and profits is subject to the following withholding, applicable on the gross amount.

(a) Distribution of dividends and profits from companies to beneficiaries situated in the country is subject to withholding on the gross amount distributed:
  — 5 percent as final tax in the case of individuals domiciled in the country (except in the case of stock dividends);
  — 5 percent on account of the general tax when paid to companies incorporared in the country (except stock dividends).

(b) Distribution of dividends and income in general to beneficiaries domiciled abroad is subject to withholding tax as follows:
  — 10 percent on payment of certain Costa Rican-source interest to legal entities domiciled abroad (e.g. on bank loans);
  — 10 percent on payments connected with the production or distribution of films (except for certain special cases) made to individuals or legal entities domiciled abroad;

- 10 percent on payments for personal services made to individuals or legal entities domiciled abroad;
- 15 percent on dividends and profits distributed to persons domiciled abroad (except stock dividends);
- 20 percent on payments to persons abroad for news and audiovisual programs and on patents, trademarks and royalties;
- 30 percent on compensation to members of Boards of Directors acting abroad, for technical assistance rendered abroad or to persons not domiciled in the country and for interest in general.

In the case of dividends, company participations and personal compensation, the Tax Administration is empowered to grant total or partial exemption from the withholding tax when it is proved that the beneficiaries are not granted a credit or deduction for the tax withheld in Costa Rica or when the credit granted is lower than the tax applicable in Costa Rica, in which case only the difference will be exempt. Corporations with bearer shares will pay annually a tax of 3 percent on the net capital, which tax cannot exceed 20,000 colones (approximately US$ 2,200).

## II. BINDING CRITERIA

The taxes are applied according to the source principle, the income obtained within the country whether by a taxpayer domiciled in the country or abroad being taxed.

## III. DEDUCTIBLE EXPENSES

In general, all the expenses necessary to produce the income can be deducted, including payment for technical assistance rendered abroad and fees for the utilization of patents and royalties paid to persons domiciled abroad.

# DOMINICAN REPUBLIC

## I. TAX STRUCTURE

The Dominican Republic is one of the few countries where a schedular tax is applied according to the origin of the income and then a surtax with progressive rates between 3 and 70 percent on the total annual income of individuals. The schedular tax is applied as follows:

- *First category:* income from real estate, 6 percent.
- *Second category:* income from movable capital (royalties, interest, etc.), 8 percent; when the income is remitted or credited to a foreign person, a final tax of 18 percent.
- *Third category:* profits of legal entities, progressive rates between 10 and 38 percent; when the profits are remitted or credited to a foreign person a final withholding tax of 18 percent is payable.
- *Fourth category:* income from independent services, 2 percent.
- *Fifth category:* income from dependent services, 2 percent.

Dividends are subject to second category tax at the rate of 8 percent and then are subject to surtax, but the tax withheld under the second category may be credited against the surtax.

Individuals are not subject to third category tax but they have to compute these profits, as well as any from participations in companies, in their surtax.

## II. BINDING CRITERIA

The Dominican Republic only follows the territoriality principle. For these purposes the law states, in general, that Dominican-source income is that derived from capital, assets or rights situated, placed or economically utilized in the country, that obtained from carrying out commercial, industrial, agricultural, mining and similar activities or from personal services, the exercise of any profession as well as income from loans and rentals, without taking into consideration nationality, domicile or residence of the parties intervening in the transaction or the place of entering into contracts.

Income derived from occasional activities carried out in the country and that derived from occasional activities performed abroad by Dominican residents is also subject to tax.

Compensation paid to teachers, public speakers, scientists, artists and the like, staying in the country not more than 12 months on cultural programs, educational or technical exchange, with international bodies, other Governments, universities or private institutions, is exempted.

There are special regimes for determining the source of income and the tax applicable in the case of exports and imports, insurance, transport and communications.

Income derived from exports and imports is determined as follows:

(a) Income derived from the export of merchandise produced, manufactured, wholly or partially, or bought in the country is deemed to be of Dominican source, even though such transactions are carried out by means of subsidiaries, branches, representatives, purchase agents or other intermediaries of individuals or legal entities resident abroad. The income is determined by deducting from the wholesale price at the place of destination the cost of the merchandise, transport and insurance expenses, commissions and sale expenses, as well as those incurred in the Republic as necessary for obtaining the income subject to tax. When no price is fixed or the declared price is lower than the wholesale price effective at the place of destination, it will be deemed, except if proved to the contrary, that there is an economic connection between the parties. In this case the wholesale price at the place of destination will be taken as the basis for determining the value of the products exported.

(b) Income obtained by foreign exporters on the mere introduction of the products into the Republic is deemed to be of foreign source.

However, when the sale price in the Republic is higher than the effective wholesale price at the place of origin, plus insurance and transport expenses, it will be deemed, except if proved to the contrary, that there is an economic connection between the parties. In this case, the difference between both prices will be considered Dominican-source income and both parties will be responsible for the respective tax.

When applying the previous ruling, if the wholesale price in the country of origin is not known or if a doubt exists that this price corresponds to the same or similar imported merchandise or there is any other circumstance that makes the comparison difficult, the determination of the income of Dominican-source will be based on the margins obtained by independent entities devoted to the same or similar activity.

In the absence of such identical or similar activity the Tax Administration will establish a net percentage on the basis of businesses that are analogous with the tested case.

## III. DEDUCTIBLE EXPENSES

As a general rule, all necessary expenses for obtaining, maintaining and keeping the income or the source are deductible.

For these purposes, the following considerations apply:

(a) All expenses incurred in the country are deductible and those incurred abroad only if they are incurred to obtain, maintain or keep the income or the source of income in the country.

(b) Royalties are defined as compensation whether in cash or in kind for the transfer of ownership, use of assets or for the transfer of rights when the value is determined in relation to production, sale, exploitation or similar units, whatever the denomination given. Royalties paid abroad can be deducted as expenses if they fulfill the general rules and the beneficiaries are empowered to deduct additionally 20 percent as expenses, but the Tax Administration can apply a different percentage and even not admit any expense at all.

(c) Financial statements of branches and subsidiaries of foreign entities will be determined for tax purposes on the basis of separate accounting records, the Tax Administration being empowered to introduce the necessary corrections in order to reflect the actual effective profits of Dominican source. When from the accounting records of the entity the profit obtained in the country cannot be determined easily and accurately, the net income of Dominican source will be determined on the basis of results of independent entities devoted to the same or similar activities. The Tax Administration is empowered to adopt other indices for tax purposes when circumstances so require, and consider that the branch or subsidiary constitutes, with the head office, an economic unit. Based on this assumption they may determine the net taxable income.

    The Tax Administration is empowered to request the necessary details or statements, duly certified, which may be necessary to clarify the commercial relations between the local entity and the foreign head office, as well as to determine reciprocal purchase and sale prices, values of fixed assets and any other data that they may require.

In the cases required by the Tax Administration, branches, agents and representatives of foreign entities in the country are obliged to file the following documents with the tax return:

- a copy of the balance sheet and of the profit and loss statement of the head office in accordance with the requirements in the country of origin for tax purposes or for distribution of dividends in the case of corporations;
- a certified copy of the contract between the head office and its representative in the country permitting the latter to intervene as such and of any other document establishing the procedure to determine the income participation of the agent or representative;
- a detailed account of original costs of products or merchandise imported into the country;
- any other document necessary to determine the taxable income or to expedite in any way the tax audit.

All pages of the above-mentioned documents have to be signed by authorized persons. The signatures have to be legalized before the respective Dominican Consul.

# ECUADOR

## I. TAX STRUCTURE

The tax on individuals is applicable on the basis (1) of progressive rates on global income, (2) a flat rate on certain categories of income as well as (3) a tax on business profits. There are also several additional taxes applicable to certain legal entities.

The progressive tax rates range between 10 and 50 percent. Earned income, whether of employees or from the exercise of a profession, in excess of 120,000 sucres annually (approximately US$ 4,000) is subject to a tax of 6 percent. Earned income obtained with the investment of capital also is subject to a 6 percent tax and profits derived from capital without personal work are subject to a tax of 18 percent.

Companies incorporated in Ecuador pay 20 percent on their profits. Permanent establishments of foreign companies pay 40 percent on the Ecuadorian-source profits.

Companies distributing dividends to individuals or to legal entities, whether nationals or foreigners, resident or non-resident in the country, have to withhold as follows:

- 20 percent on the dividends of shares (nominative shares according to a decision of the Andean Pact);
- 40 percent on dividends of nominative shares remitted to foreign shareholders resident abroad.

Profits obtained in the country by companies incorporated abroad and remitted to their head office are subject to a final tax of 40 percent.

Interest, royalties and other profits remitted abroad are subject to a final tax of 40 percent on the income considered to be Ecuadorian-source.

There is a special regime applicable to hydrocarbon companies.

## II. BINDING CRITERIA

The tax is applicable to Ecuadorian-source income and to foreign-source income in special cases established by law.

Profits derived from independent professional activities by foreign individuals or legal entities resident abroad who occasionally work in Ecuador are taxed; the tax is applied on 60 percent of the total gross amount received or credited to them, provided that they are in the country less than one year. If they are in the country for more than one year the tax is computed on 100 percent of the amount received or credited, but in this case normal rules are applied for the determination of taxable income. Also considered Ecuadorian-source income is 80 percent of compensation received for professional services rendered abroad by individuals or legal entities, whether nationals or foreigners.

In general, technical assistance expenses are deductible providing the services are rendered directly, not through third parties, and that the services are actually rendered. Rentals paid for equipment, machinery, ships, or any type of transport vehicle utilized in economic activities in the country, belonging to individuals or legal entities resident abroad whether the contracts are entered into within or outside of the country, are considered to be income of Ecuadorian source.

A permanent establishment of a foreign enterprise is deemed to exist if there is a fixed place for carrying out the business activities of the enterprise in Ecuador, whether total or partially, including research and consulting, and other establishments of a productive nature. In this sense the law refers expressly to branches, agencies, offices, warehouses, mines, oil wells, plantations, forests, factories, workshops, research establishments, consulting agencies and other permanent places of business of the foreign enterprise. On the other hand the regulations establish that a permanent establishment is deemed to exist when the foreign enterprise maintains in the country a fixed place of business or has for more than 12 months a place to carry out technical services and when its agent has the power to conclude contracts on behalf of the foreign enterprise or when he is under a labour contract and habitually carries out commercial transactions on behalf of the enterprise, has usually in deposit assets for sale and delivery, and principally if the administrative expenses (in particular the rental of the offices) are paid for by the foreign company.

The income will also be considered to be of Ecuadorian source if it is:

— compensation obtained by Ecuadorians or foreigners resident in Ecuador from international bodies or foreign bodies and Governments;
— compensation received by Ecuadorians or by foreigners living abroad and working for the Government or for national bodies or enterprises or for foreign enterprises domiciled in Ecuador;
— compensation of Ecuadorians and foreigners for occasional services rendered abroad provided they are paid by public national bodies or by enterprises domiciled in Ecuador.

In the three above-mentioned instances a credit is granted for the tax paid abroad according to the certificates of the respective tax authorities.

— compensation received by foreigners who are working in Ecuador for foreign enterprises when they remain in the country for more than six months;
— fees and compensation paid to Ecuadorian professionals by national or foreign bodies or individuals or legal entities, domiciled or not in the country;
— in the case of compensation paid to professionals for services rendered abroad to national bodies or enterprises or to permanent establishments of foreign enterprises, 80 percent of the compensation is considered to be Ecuadorian-source income.

For foreign-source profits which are not subject to tax based on the source principle or in the case of exempt income, a tax credit according to the regulations will be granted.

When foreign enterprises distribute dividends from foreign-source profits to companies incorporated in the courntry, a tax credit is granted subject to reciprocity, but the credit so granted cannot exceed the amount of the Ecuadorian tax on such dividends.

### III. DEDUCTIBLE EXPENSES

Commissions and other expenses paid abroad can be deducted as expenses under certain conditions, as well as fees for professional services provided abroad. Commissions and other expenses will be determined according to the contract; in the absence of this, it is deemed that the expenses do not exceed 2 percent of the income obtained from export or sales abroad.

## EL SALVADOR

### I. TAX STRUCTURE

There is a general income tax based on progressive rates (between 2.5 and 15 percent for legal entities and between 2.85 and 60 percent for individuals).

There are also two special taxes on the profits of companies incorporated in the country: on profits which are capitalized (as a final tax and on the basis of progressive rates between 5 and 12 percent), and on retained earnings (a provisional tax applied on the basis of progressive rates between 4 and 13 percent).

Finally there is a wealth tax ("De Vialidad Seria A") applicable on the capital of individuals and legal entities on the basis of progressive rates.

A 20 percent tax is applied on individuals and legal entities not domiciled in El Salvador and the same tax is applicable as a final withholding on dividends remitted abroad. In relation to the profits distributed by companies incorporated in the country to shareholders domiciled in El Salvador, the amounts distributed or accrued are not subject to withholding but they must be taken up in the personal tax return.

### II. BINDING CRITERIA

Individuals domiciled in El Salvador, whether nationals or foreigners, pay income tax on a world-wide basis. Individuals not domiciled in El Salvador, whether nationals or foreigners, only pay tax on national-source income.

Legal entities, whether national or foreign, domiciled or not in the country, pay tax on the total income obtained within the national territory.

Income is deemed to be obtained in El Salvador if it is derived from assets located or from activities carried out in the country even though it is received or paid abroad and also includes compensation paid by the Government, municipalities or official bodies to their employees abroad. For these purposes:

— loans are deemed to be located in the domicile of the debtor;
— industrial and intellectual property and similar rights of an economic nature that authorize the carrying out of certain activities according to the law are deemed to be located where they are officially registered;
— concessions are deemed to be located where they have been legally granted.

Regulations define royalties as any amount paid whether in cash or in kind, determined in relation to a unit of production, sale or exploitation, whatever the denomination given in the contract may be; they are deemed to be of national source when they are derived from assets located in the country.

Taxpayers who have to include income of foreign source in their tax return can credit against their income tax the tax of a similar nature paid abroad.

The amount of the credit will be computed on a country by country basis. The credit against the national tax, in relation to any income tax paid in any Central American country, will not exceed the proportion existing between the net income of the taxpayer derived from such country and the total net income of the taxpayer in the same tax year. Income of foreign source cannot exceed the total net income. In relation to any other foreign country, the credit will not exceed 85 percent of the amount computed or explained in this paragraph for the purpose of calculating the limit of the credit and the net income will be determined without any deduction for personal consideration or children. Any amount of credit not utilized in a given year can be used in others.

When in accordance with the legislation of a Central American country persons domiciled in one of these countries are not obliged to pay tax on the income of Salvadorian source, the persons domiciled in El Salvador do not have to include in their tax return the income obtained in these other countries.

The taxpayer who applies this reciprocity principle must prove the existence and application of the respective foreign legislation, justifying its text, duration and sense by means of a certficate of two lawyers in professional exercise in the respective country, which certificate must be presented duly legalized.

### III. DEDUCTIBLE EXPENSES

As a general principle the net income is determined by deducting from the gross income the necessary expenses for producing and maintaining the income; as a special rule, branches may deduct up to 5 percent of the income as well as a proportion of the general expenses of the head office.

# GUATEMALA

## I. TAX STRUCTURE

An annual tax is applied on the total income obtained by individuals and legal entities. For these purposes there is a progressive scale between 5 and 48 percent applied to all taxpayers. There is in addition a 10 percent surcharge if the total taxable income exceeds 10,000 quetzales (same value as American dollars).

In addition there is the "Impuesto masivo" on remittances abroad. Under this tax, royalties, rents, commissions, interest and fees are taxed at a general rate of 12.1 percent by means of withholding when the remittances during the tax year exceed 10,000 quetzales and 11 percent if lower than this figure in which case it is a final tax.

Dividends are not taxed when distributed by companies incorporated in the country to beneficiaries domiciled in Guatemala; when remitted abroad, they are subject to a final withholding of 10 percent.

## II. BINDING CRITERIA

Income of Guatemalan source is taxed whatever may be the nationality, residence or domicile of the recipient or of the parties intervening in the transaction or wherever the place of agreement of the contract. In general income is deemed to be of Guatemalan source if it is derived from tangible or intangible assets located, utilized or situated in the country, or derived from any activities carried out in the Republic. Compensation derived from personal work performed occasionally abroad by persons resident in the country which are paid from the Republic are also deemed to be income of Guatemalan source. Interest derived from loans from abroad is also considered to be of Guatemalan source, wherever the contract, the domicile of the parties or place of payment of interest or of the principal may take place.

Pensions from abroad, received in Guatemala by foreign residents not carrying out in the country any profitable activity, are not considered income of Guatemalan source.

In the case of branches and subsidiaries of foreign entities, the tax will be assessed on the basis of the accounting records of such branches or subsidiaries and the Tax Administration will make the necessary reassessment in order that the above-mentioned enterprises pay taxes on actual profits of Guatemalan source.

Compensation paid by international bodies to their employees who come to the country to render services on behalf of such bodies will not be subject to tax, except when the employee resides in Guatemala for more than six months prior to his recruitment and also when the employees are of Guatemalan nationality.

Interest on loans from abroad is exempt when the obligation to repay the loan is originally agreed and effectively repaid after 18 months (this provision does not cover loans granted by a bank operating in Guatemala through an agency or branch).

## III. DEDUCTIBLE EXPENSES

In general, expenses incurred abroad are deductible from gross income under certain conditions which are as follows:

(a) Payments for technological research will be deductible provided that they are connected with the activity of the taxpayer and do not exceed 20 percent of paid-up capital and reserves at the beginning of the tax period, and they can be amortized during a period of up to five years.

(b) Payments for advice of foreign professionals rendered in the country are deductible provided that the taxpayer has obtained authorization of the Ministry of Labour to contract such services and it is proved to the Tax Administration that the foreign advice is connected with the activity of the taxpayer and its amount is less than 1 percent of the gross receipts of the taxpayer, except when they are considered start-up expenses.

(c) Commissions and consulting fees paid to head offices by branches or subsidiaries domiciled in Guatemala are deductible up to an amount of 1 percent of the gross receipts of the tax period; salary and compensation paid as participations or expenses for controlling or supervising branches are not deductible except in the case of salaries paid from abroad to employees working in the country and subject to Guatemalan income tax.

(d) Royalties will be deductible provided they have been authorized by the Ministry of Economy and do not exceed 15 percent of the annual gross sales connected with such royalties.

(e) All expenses incurred in travelling abroad are deductible in the case of legal entities but within certain limits and conditions determined by regulations.

# HONDURAS

## I. TAX STRUCTURE

The tax is applied on the total net income obtained during the tax year by individuals and legal entities based on a progressive scale between 3 and 40 percent, applicable for both individuals and legal entities. Dividends distributed by companies incorporated in the country are subject to a final withholding of 10 percent and those distributed as stock dividends, 5 percent. Profits and dividends remitted abroad are subject to a final withholding of 15 percent.

## II. BINDING CRITERIA

The tax is applied on a world-wide basis in the case of individuals and legal entities whatever their nationality may be, when they are domiciled or resident in Honduras, independently of the place where income is distributed or paid. Persons not resident or domiciled in Honduras are subject to tax on income of Honduran source, derived from assets situated in Honduras, from services rendered in the national territory or from business carried out by persons domiciled or resident in the Republic, even though the payments are made or credited to the recipient by persons resident or domiciled in the country or abroad.

For the purposes of determining the tax on Honduran-source income applicable to non-resident or non-domiciled persons, the tax will accrue at the moment of the remittance abroad or when the payment is credited or made available to the beneficiary and the tax will be calculated according to the type of income as follows:

| | |
|---|---|
| — Royalties | 10 percent |
| — Interest | 5 percent |
| — Personal compensation, in general | 15 percent |
| — Dividends and profits | 15 percent |
| — Rentals of movables or real estate | 10 percent |

For the purposes of the source concept and in the case of income derived from capital, it will be deemed that the income is of Honduran source when the assets constituting the capital are situated in Honduras. In the same way gains derived from the transfer of shares or securities issued by companies constituted under Honduran law are deemed to be of Honduran source. In the case of earned income it will be deemed that it is of Honduran source when the services are rendered or the work is performed in Honduras. However, when the services are rendered abroad, the source of income will be deemed to be of Honduran source if it is paid from Honduras. When the income is obtained by the joint use of capital and personal services, the location of the source will be determined in the same way as for income derived from capital, already explained.

Income derived from export is totally of Honduran source. When there is no value assigned or when the export value is lower than the wholesale price in the place of destination it will be deemed, except if proved to the contrary, that there is an economic connection between the exporter and the importer; in this case the wholesale price at the place of destination will be taken for purposes of determining the value of the exported products and the corresponding final profits.

Persons who are temporarily in the Republic and carry out activities of any nature or render services producing taxable income have the right to file a tax return before leaving the country and to ask for the corresponding assessment.

Merchant ships are also subject to tax under the following conditions:

- that they operate under Honduran license or flag;
- that they habitually navigate in territorial waters or receive income of Honduran source.

### III. DEDUCTIBLE EXPENSES

The law and regulations allow, in general, the deduction of all expenses duly proved and that have been paid or incurred for the production of the income.

## MEXICO

### I. TAX STRUCTURE

There are two general income taxes:

- tax on corporate income
- tax on individual income

#### Tax on corporate income

The law taxes all types of income, whether in cash or in kind or merely accrued, derived from commercial, industrial, agricultural, stock raising or fishing activities, obtained by individuals or legal entities. For purposes of the tax, the law distinguishes the "causantes menores", that is, individuals earning less than 1,500,000 pesos a year (approximately US$ 68,000), and the "causantes mayores", that is, all the remainder of individuals and legal entities.

(a) The progressive scale of rates ranges between 5 and 42 percent and applies:
  - on the total annual income of the "causantes mayores", with special rates for agricultural, industrial and publishing activities;
  - on the total income of the "causantes menores" assessed on the basis of profitability coefficients according to the type of activity.

(b) The tax is also applied on the gross income of foreign individuals resident abroad and foreign enterprises domiciled abroad who earn the following income of Mexican source:
  - Rentals from movables, and under certain conditions interest paid by persons resident in the country, dividends or profits paid by foreign enterprises resident abroad if the recipient receives them as a partner or shareholder and opts not to accumulate the dividends ........ 21 percent
  - Interest in certain cases, profit on distribution of foreign publication and technical assistance and royalties if the taxpayer opts not to accumulate them ........ 10 percent
  - Reinsurance premiums or reguarantees transferred by Mexican companies if in the country of the residence of the reinsurers or reguarantors reciprocity does not exist, and income from public spectacle enterprises acting in a given place less than a month ...... 4 percent
  - Interest in certain cases ........ 42 percent

(c) In the case of royalties paid by persons resident in the country for publicity or for exploitation of patents, industrial or commercial designs, technical assistance or technological transfer and for professional services, the tax will be applied to the gross income but on the basis of the progressive scale of rates mentioned above.

#### Tax on income of individuals

A tax is applied on the annual income of all individuals on the basis of progressive rates ranging between 3.1 and 55 percent. During the tax year the taxpayers pay taxes on account of the final tax or by means of a withholding, as follows:

| | |
|---|---|
| — withholding on salaries and for the rendering of dependent personal services ........ | progressive scale ranging between 3.1 and 55 percent |
| — fees and compensations for rendering of independent personal services ........ | fixed rates and 20 percent as a general rate |
| — real estate rentals ........ | idem |
| — capital gains ........ | general scale, on 30 or 40 percent of the gains depending on the cases |
| — acquisition of assets (donations, etc.) ........ | 20 percent on the gross |
| — profits of business enterprise ...... | tax on corporate income |
| — dividends and distributions of profits ........ | the recipients can credit certain percentages on a part of the tax paid by the company |
| — interest ........ | 21 percent on the gross as a final tax and a provisional 15 percent in respect of residents holding nominative securities |

### II. BINDING CRITERIA

(a) The following taxpayers pay tax on world-wide income:
  - individuals and legal entities of Mexican nationality;
  - foreign individuals resident in Mexico and legal entities of foreign nationality established in the country;
  - agencies and branches of foreign companies established in Mexico.

(b) The following taxpayers pay tax only on income of Mexican source:
  - foreign individuals resident abroad and legal entities of foreign nationality incorporated and established abroad.

In general, income is deemed Mexican source when it is obtained from persons resident in the country. In the case of transfer of shares, bonds, certificates of financial institutions, loans, mortgage bonds, and certificates of participation (mutual funds) it is deemed to be Mexican-source when the securities have been issued in Mexico.

In the case of compensation paid to members of Boards of Directors and similar bodies, it is deemed to be Mexican-source when these compensations are paid in the country or abroad by resident companies.

In the case of interest derived from transactions with registered foreign financial institutions, the source is deemed to be located abroad when that interest is paid by financial institutions or by branches of foreign banks authorized to carry out business in Mexico.

In all the previous cases, when it is foreign-source income, the taxpayer can credit against the Mexican tax the tax paid abroad but up to the limit of the tax that would have been paid in Mexico. For these purposes tax exemptions granted abroad are included in the credit against Mexican tax as if they had been paid (tax sparing).

### III. DEDUCTIBLE EXPENSES

In determining the net taxable income of companies, it is possible to deduct the necessary expenses connected with the business, provided they are in reasonable proportion with the transactions of the taxpayer.

In the case of payments for technical assistance to persons resident abroad, it must be proved to the Tax Administration that the services are rendered directly and not through third parties, that the services are actually provided and that the contract is duly registered in the "Registro Nacional de Transferencia de Tecnología".

Legal entities of foreign nationality resident abroad that carry out business occasionally in the country must account for the taxable profit in respect of each operation by deducting from the gross income the cost and the necessary expenses incurred in the operation. In these cases, the purchaser has to withhold provisionally 20 percent of the total proceeds but the Tax Administration is empowered to authorize a lower withholding based on a justified petition of the seller.

## NICARAGUA

### I. TAX STRUCTURE

The total net income obtained in the tax year by individuals and legal entities is subject to tax. For these purposes a scale based on progressive rates is applied to both individuals and legal entities, ranging between 6 and 50 percent but in no case may the total payable exceed 40 percent of taxable income. In the case of legal entities, only the entity is subject to tax and therefore the partners or shareholders do not include in their tax return dividends and profits received; neither is a withholding tax applied to such income whether paid to beneficiaries domiciled in the country or abroad.

### II. BINDING CRITERIA

The tax is applied only to income of Nicaraguan source which is income derived from assets located in the country, services rendered in the territory or business carried out or producing effects in the Republic, whatever the place of payment of the income may be.

Profits derived from the export of goods produced, manufactured, processed or bought in the country are of Nicaraguan source.

Any remittance abroad of goods produced, manufactured, processed or bought in the country, done through subsidiaries, branches, representatives, purchase agents or other intermediaries of individuals or foreign legal entities, is considered to be an export.

Profits obtained by foreign exporters, by merely introducing the goods into the Republic, are of foreign source. However, when the sale price is higher than the wholesale price in the place of origin of the merchandise, plus transport and insurance costs, it will be deemed, except if proved to the contrary, that the parties involved are economically connected, the difference being considered income of Nicaraguan source and both parties are jointly liable for the payment of the tax.

### III. DEDUCTIBLE EXPENSES

All the expenses effectively paid and necessary or proper for the production or for the maintenance of the source of income are deductible. However, the law establishes that the amounts paid or credited to persons not domiciled in Nicaragua will not be deductible, unless the payer has withheld and paid the corresponding tax.

## PANAMA

### I. TAX STRUCTURE

A general tax is applicable on the income of individuals and legal entities. The progressive scale for legal entities ranges between 20 and 50 percent, and in the case of individuals, between 2.5 and 56 percent. In the case of legal entities only the entity is subject to tax and the partners or shareholders do not have to include dividends or profit participations in their tax return. However, the distributions, whether to beneficiaries domiciled or not in the country, are subject to a final withholding tax of 10 percent.

Remittances abroad of other Panamanian-source income are subject to the progressive scale of rates for individual(for individuals or legal entities as the case may be) on:
— 100 percent of payments for personal services;
— 50 percent of royalties, rentals and any other payments.

### II. BINDING CRITERIA

The tax is applied on the total net annual income of Panamanian source, notwithstanding the nationality, domicile or residence of the taxpayer or the place of entering into the contract, including, inter alia, income derived from real estate located in the country, profits produced by assets, capital, securities or rights situated, invested or economically utilized in the Republic and those originated by civil, commercial, industrial or similar activities and for the exercise of any profession and for the performance of any service within the territory. However, income derived from the following is not deemed to be of Panamanian source:

— invoicing for a higher value than that invoiced to Panama from an office established in Panama for the sale of merchandise, provided that such merchandise does not enter into Panama;
— directing, from an office established in Panama, transactions to be implemented or which have effect abroad;
— distributing dividends or profit participations from legal entities, when such distributions do not derive from income of Panamanian source;

— interest, financial commissions and the like, derived from loans and financial transactions carried out with legal entities, independently of the place of domicile or incorporation, provided that those entities receive or accrue only income of foreign source.

Income derived from exports, carried out by companies established in Free Zones within the Republic, has a special treatment and is exempted from the 10 percent tax on dividends and profits distributed by such companies provided it proceeds from export transactions.

## III. DEDUCTIBLE EXPENSES

As a general rule, all the expenses incurred for the production of the income or for the maintenance of the source of income are deductible. As regards expenses incurred abroad, they are deductible if it is proved that they were actually incurred and fulfill the previously mentioned rule.

# PARAGUAY

## I. TAX STRUCTURE

Tax is applied on the total net income obtained by taxpayers. There is a progressive scale ranging between 5 and 30 percent in the case of individuals, and between 25 and 30 percent in the case of legal entities.

As a general rule, income from personal services and from agricultural activities is not subject (in the latter case a substitutive tax on the transfer of cattle is applicable). Neither is a tax applied on the distribution of dividends or profits to beneficiaries domiciled in the country.

## II. BINDING CRITERIA

The tax is applied only on income of Paraguayan source.

When any income of Paraguayan source is paid or credited to persons not domiciled in the country, a withholding tax will be applied as an only and final tax at the following rates:

(1) Dividends and profits, 10 percent on the gross amount. However, dividends and profits reinvested in enterprises of the country are exempted from this tax.
(2) Compensation or salaries of members of Boards of Directors or similar bodies acting abroad, 30 percent on the total gross payments.
(3) Fees, commissions, interest, rentals and any other income not mentioned under (1) and (2), 30 percent on 85 percent of the gross amount (on 90 percent in the case of royalties).

### Domicile

For the purposes of withholding, persons will be considered domiciled in the country in the following cases:

— individuals whether nationals or foreigners who have stayed in Paraguay more than 180 days, continuously or not, during the tax year or in the last 12 months;
— branches, agencies, subsidiaries, correspondent agencies and any other form of representation in Paraguay of individuals or legal entities not domiciled in the country, if they are registered with the Tax Administration;
— legal entities incorporated in Paraguay with the sole exception of their agencies or branches established abroad.

## III. DEDUCTIBLE EXPENSES

All expenses and payments made abroad, duly justified and approved by the Tax Administration, may be deducted from gross income if they are connected with the activity of the taxpayer provided they do not exceed 5 percent of the annual taxable income.

In the case of interest remitted abroad, payments made to the head office are not a deductible expense.

Enterprises or legal entities are subject to tax on all income of Paraguayan source. The Tax Administration will assess the taxable income of branches, agencies and subsidiaries of foreign enterprises on the basis of separate accounting records but they are empowered to introduce the necessary corrections to determine the actual results of Paraguayan source. In the absence of sufficient accounting records or when these do not show accurately the net profit of Paraguayan source, the Tax Administration may consider that the subsidiary or the branch and the head office constitute one economic unit in order to assess the net income.

# PERU

## I. TAX STRUCTURE

The total net income obtained by the taxpayer is subject to tax. In the case of individuals a progressive scale is applicable, the rates ranging between 5 and 65 percent. In the case of legal entities the progressive scale ranges between 20 and 55 percent. The tax applicable on individuals domiciled in the country cannot exceed 40 percent on taxable income from dividends. As a general rule, legal entities have to withhold 25 percent on dividends distributed to beneficiaries in the country. The shareholders compute the dividends in their tax returns and take as a credit against the final tax the 25 percent withheld.

Individuals not domiciled in the country are subject to the following rates:

— dividends .......... 30 percent
— profits of branches and agencies in the country available for remittance abroad .......... 30 percent
— compensation for personal services rendered in the country (the general progressive rates for individuals are applicable)......
— compensation for personal services rendered abroad and other income .......... 40 percent

Legal entities not domiciled in the country are subject to the following rates:

— dividends, general rate .......... 40 percent
— profits of branches available for remittance abroad .. 30 percent
— interest .......... 10 percent
(However, tax at the rate of 40 percent is applicable in the case of enterprises economically connected.)
— royalties
(They are subject to the progressive scale of rates applicable to legal entities, plus a 30 percent tax on the income available for remittance abroad.)

## II. BINDING CRITERIA

Persons domiciled in the country are subject to tax on a worldwide basis. Persons not domiciled in the country are subject only on income of Peruvian source.

### Income of Peruvian source

In general and whatever the nationality or domicile of the parties to the transaction and the place of agreement or fulfillment of the contract, income will be considered of Peruvian source on:

(a) profits derived from properties located in the territory;

(b) profits derived from capital, assets or rights located or economically placed in the country; and

(c) profits derived from personal services and from civil and commercial activities of any nature carried out in the territory.

In addition, the law also considers as income of Peruvian source:

(a) interest derived from loans granted abroad to individuals or legal entities domiciled in Peru, even though the payment of the interest or the amortization of the capital is made abroad (for the application of this provision it does not matter where the contract is entered into);

(b) interest from loans guaranteed in rem when the assets guaranteeing the transaction are located in the country;

(c) interest from bonds, when the issuing entity is domiciled in the country wherever the bonds may be issued or the assets guaranteeing the transaction are located;

(d) salaries or any kind of compensation paid by enterprises domiciled or incorporated in the country to members of Boards of Directors or similar bodies acting abroad;

(e) fees or compensation for technical advice or similar assistance provided from abroad to individuals and legal entities domiciled in the country; however, fees and compensation for technical, economic, financial or similar assistance provided from abroad by governmental entities or international or financial institutions are not subject to tax.

According to the general rule, compensation for personal services fully rendered abroad is not considered income of Peruvian source, and therefore the respective payments are not subject to withholding.

The cases mentioned under (d) and (e) above are exceptions to this provision. We would point out that the expression "similar assistance" in paragraph (e) does not refer to the compensation. That is, the provision does not affect any payment for services rendered abroad but only technical assistance or the like. This has been confirmed by regulations when they point out indirectly that the assistance can be of an economic or financial nature.

### Activities rendered partially in the country and partially abroad

There is a presumption "juris et de jure" that is not rebuttable that net profits obtained by taxpayers domiciled abroad, for activities carried out partially in the country and partially abroad, are arrived at by deducting from the gross profits the percentages established by law. When the activities are carried out by taxpayers domiciled in the country it is presumed "juris et de jure" that the income obtained is all of Peruvian source, except in the case of branches and agencies of foreign enterprises whose profits will be determined according to the rules already mentioned.

The previous provisions include transport and communication activities between the Republic and other countries, providing of news by international agencies, insurance, reinsurance and retrocession transactions, and the rental or any other form of exploitation of films, magnetophonic tapes, master copies and other equipment used for projecting or reproducing images and sounds.

Taxpayers domiciled in the country will add the profits and losses of Peruvian source obtained from different activities. They will treat foreign-source profits in the same way, but only if such transactions abroad give a positive result will they be added to the net income of Peruvian source. Net losses of foreign source cannot be set off for purposes of determining the taxable income.

## III. DEDUCTIBLE EXPENSES

The following principles apply as regards deductible expenses:

(a) As a general rule all expenses necessary for the production or maintenance of the source of income of the business or activity subject to tax are deductible, unless there is an express prohibition by law.

(b) Royalties are defined as any compensation in cash or in kind derived from the transfer of ownership, use of movables or for the transfer of rights, whether definitive or temporary, when the amount is established in relation to production, sale, exploitation or any other units used as reference. Royalties, fees and other compensation for assistance, directing or for services rendered abroad can be deducted. As regards fees and other compensation for assistance, the deduction is admissible provided that the payments do not exceed 1 percent of income or 3 percent of the amounts invested; however, in special cases higher percentages may be accepted. Beneficiaries of royalties domiciled abroad who habitually perform research and incur expenses to obtain assets which can produce such royalties can deduct 5 percent from the gross royalties.

(c) As regards expenses incurred abroad it is presumed, unless it can be proved to the contrary, that such expenses have been incurred for the production of income of foreign source.

(d) Commissions originated abroad for purchase or sale of merchandise or any kind of goods can be deducted but only up to the percentage usually paid for such commissions in the country where they originate.

(e) Interest paid to foreign entities economically connected with the debtor as a general rule is not deductible in the amount that the rate exceeds the limits established by regulations in relation to the type of transaction, nor is interest on credits or loans deductible if it exceeds four times the paid-up capital of the debtor.

# URUGUAY

## I. TAX STRUCTURE

The "Impuesto a las Rentas de la Industria y el Comercio" is applied on profits derived from industrial, commercial and similar activities carried out by individuals and legal entities. Individuals are not subject in general to income tax except when they obtain profits from commercial, industrial or similar activities, produced by the joint utilization of capital and personal services in normal profitable activities. The rate of the tax is 25 percent.

In addition, individuals and legal entities domiciled abroad are taxed on rentals, transfer of ownership or the use of trademarks and patents, payments for technical assistance rendered abroad and distributions of profits of companies and branches remitted abroad, except dividends. Profits obtained in Uruguay by persons resident abroad are subject to two cumulative taxes:

— 25 percent;
— 20 percent on profits remitted abroad.

A wealth tax is also applicable on individuals and legal entities.

## II. BINDING CRITERIA

Only income of Uruguayan source is taxed, i.e. income derived from activities carried out in Uruguay, from assets situated or rights utilized in the country, whatever the nationality, domicile or residence of the parties intervening in the transactions or the place of entering into the contract. As an exception, payments for technical assistance rendered abroad are also taxed.

As regards withholding applicable to income remitted abroad, the rules are as follows:

- rentals, transfer of ownership or of the use of trademarks, patents, models, secret formulae or processes, exclusive information or technical assistance, 25 percent on the gross income;
- profits of commercial enterprises, 25 percent plus 20 percent on the income remitted abroad;
- other income, 25 percent on 30 percent of the income.

## II. DEDUCTIBLE EXPENSES

The following rules apply to deductible expenses:

a) As a general principle, all necessary expenses for producing and maintaining the income are admissible if duly justified.

b) Expenses incurred abroad are deductible as long as they are necessary to obtain the income of Uruguayan source, providing the amounts are judged reasonable by the Tax Administration.

c) Net income of Uruguayan source of branches or agencies of foreign entities is determined on the basis of separate accounting records, the Tax Administration being authorized to introduce the necessary corrections to appraise the actual profits of such establishments. When the accounting records do not accurately reflect the net profits of Uruguayan source, the Tax Administration will determine the taxable income on the basis of the volume of business and adequate indices for these purposes.

The Tax Administration is empowered to request the necessary details or statements, duly certified, which may be necessary to clarify commercial relations between the local entity and the foreign head office and to determine reciprocal purchase and sale prices, values of fixed assets and other data which could be considered necessary.

d) Expenses incurred by the head office to produce and maintain income of Uruguayan source are always accepted provided that their origin and nature are duly proved. For these purposes it will be necessary to file documentation certified by independent auditors of the country of origin, duly translated and legalized, certifying the amounts and including a breakdown of the ratio of expenses between the different agencies and branches and the head office, in order to appraise the amount incurred for the production of income of Uruguayan source. The above-mentioned certificate must establish that expenses attributed to the branch in Uruguay have not been deducted in any other foreign tax assessment.

e) The deduction for interest paid or credited cannot exceed the rate applicable by the Central Bank according to Law 14,095 of November 7, 1972. In the case of interest on loans granted abroad, the rate will also be limited to the current rate used in the borrower's market.

# VENEZUELA

## I. TAX STRUCTURE

Different progressive rates of tax are applied on legal entities and joint ownerships on one hand and individuals on the other. Additional taxes are applied to taxpayers obtaining profits derived from extractive, mining and hydrocarbon industries, and there is a 32 percent tax on occasional gains derived from lottery premiums, race courses and such.

Applicable rates are as follows:

### 1. Mining

Enterprises devoted to the exploitation of mines and connected activities, such as refining, purchase and transport, are taxed at a rate of 60 percent on the profits obtained.

### 2. Hydrocarbon enterprises

Enterprises devoted to the exploitation of hydrocarbons and connected activities such as refining, transport or acquisition of hydrocarbons and their derivative products for export purposes pay tax at the rate of 67.7 percent.

### 3. Individuals

The total annual income of individuals carrying out any activity other than mining is taxed at a progressive rate scale between 4.5 and 45 percent.

In the case of individuals not resident in the country, the tax applicable is as follows:

- compensation derived from dependent services........20 percent
- professional fees derived from independent non-commercial services..................30 percent
- dividends distributed, including stock dividends.......20 percent

### 4. Corporations

Corporations carrying out any activity other than mining and hydrocarbon exploitation are taxed at progressive rates between 18 and 50 percent.

### 5. Special tax rates

They are applied in the following cases:

- limited liability companies;
- interest from loans granted by foreign financial institutions not domiciled in the country is taxed at the rate of 10 percent;
- lottery prizes, racecourse winnings and similar gains, obtained by any person or joint ownership, are taxed at the rate of 32 percent, which can be reduced in certain cases to 16 percent.

Dividends are taxed on distribution by a withholding of 7 percent and then incorporated in the personal tax return; on the other hand, dividends distributed to foreign persons are taxed by means of a final withholding of 20 percent and the same tax is applicable in general to any remittance of profits abroad made by branches to their head offices.

## II. BINDING CRITERIA

The tax is applied on income of Venezuelan source, that is, on profits derived from economic activities carried out in the country or assets situated in the territory.

Profits are those arising from econmic activities performed in Venezuela or from assets situated in the country, when any of the factors giving rise to the income occurs within the national territory, whether these refer to the exploitation of the soil or of the sub-soil, the transfer, exchange or ceding of the use or possession of movables or inmovables, tangibles or intangibles, or services rendered by persons domiciled, resident or transitorily in Venezuela, as well as compensation, fees or payments for technical assistance or technological services utilized within the country.

Official activities abroad of public servants of the National Administration, States or municipalities, as well as representatives of autonomous official bodies or from State enterprises to whom functions or research are entrusted outside the country, are deemed to be performed within the territory provided that the respective income is exempted in the place of accrual.

The Executive is empowered to exempt from the tax, inter alia, fees, salaries and other compensation paid to technicians or experts sent by foreign non-profitable institutions or foundations to render technical assistance in relation to projects previously approved by the National Government, as well as compensation and similar payments for technical assistance or technological services utilized in the country for the benefit of the public or private sector. However, income subject to tax abroad will only be exempted in the country as long as it means an effective advantage to the taxpayer.

— Income obtained by taxpayers rendering technical assistance or technological services from abroad to persons or joint ownerships that utilize them in the country or transfer them to third parties will be taxed at a percentage determined by regulations, whatever the method of payment or denomination may be. The percentage will be fixed taking into account the nature and complexity of the technical process contributed.

  When, as agreed by the parties, the income is derived from technical activities developed partly abroad and partly in the country, the Venezuelan-source income will be deemed, on the basis of the percentage fixed by Regulations, and this will be taxed after deducting costs and expenses permitted by Law.

— Net profits of taxpayers importing to the country merchandise on consignment will be 25 percent of gross receipts. These receipts will be based on the proceeds of the sales in Venezuela.

— Net profits of taxpayers not resident or domiciled in the country derived from professional non-commercial activities will be based on 90 percent of gross receipts.

— The transportation expenses of exported merchandise up to the foreign port of destination will be deductible, when the taxpayer computes as gross income the effective price of the exported merchandise in the foreign port of destination.

— In the case of exports of goods manufactured in the country or the rendering of services abroad of Venezuelan source, all the normal and necessary expenses incurred abroad with reference to these exports or activities may be deducted, such as travelling expenses, advertising, office expenses, exhibitions or fairs, including the transportation of the goods to be exhibited in such events.

### III. DEDUCTIBLE EXPENSES

For determining profits the law allows the deduction from gross income, as a general rule, of all the normal and necessary expenses incurred in the country.

Among the deductions accepted, royalties and similar payments are allowed, as well as compensation, fees and similar payments for technical assistance or technological services utilized within the country; for this purpose the withholding will be applied on 90 percent of the respective payments.

## B. GENERAL CONCLUSIONS ON THE STRUCTURE OF INCOME TAX IN 18 LATIN AMERICAN COUNTRIES

### B.1. Conclusions concerning the structure of income tax effective in 18 Latin American countries

Table 1, on the tax structure of 18 Latin American countries, gives rise to the following conclusions:

1. There are 14 countries applying a tax on the income of taxpayers (basically individuals and legal entities). Among them, there is one country (Paraguay) in which the major part of income derived from personal services and from agriculture is not subject. El Salvador applies, in addition, taxes on capitalized profits or on retained earnings of corporations.
2. There are three countries (Chile, the Dominican Republic and Ecuador) maintaining a mixed system, under which a schedular tax is applied on certain categories of income and then a progressive surtax on the total income of individuals.
3. There is one country (Uruguay) that does not apply income tax on individuals, except if they carry out commercial or industrial activities employing jointly capital and personal services. However, a tax is applied on the potential income of land (agriculture).
4. Eleven of the 14 countries mentioned above apply a global tax, with different rates on both legal entities and individuals, whilst in only three countries (Guatemala, Honduras and Nicaragua) is there a common progressive scale applicable to both taxpayers.
5. According to Table 2, there are seven countries applying a flat rate on companies, whilst the remaining 11 countries apply progressive rates.
6. Among the 18 countries under study, it can be seen that:
   - *four countries* (Guatemala, Nicaragua, Paraguay and Uruguay) tax only profits of the entity without taxing distributed dividends. Among them, there are two countries (Nicaragua and Uruguay) that also do not tax dividends remitted abroad (see Table 3);
   - *two countries* (Chile and Mexico) tax the profit of the entity and not dividends distributed but it is obligatory to include them in the total income of the beneficiary and a credit is granted for the tax already paid by the company. In addition, Chile also does not apply tax on dividends remitted abroad (see Table 3);
   - the other countries apply the traditional system of taxing at the same time the profit of the entity and the distributed dividends under various methods of a provisional or final withholding.
7. There are six countries applying different types of wealth tax (Argentina, Colombia, Costa Rica, El Salvador, Peru and Uruguay).

### B.2. Conclusions concerning the binding criteria applied by Latin American countries

According to Table 4:

1. All the countries concerned, without exception, tax the income obtained in the country by individuals or legal entities, domiciled or incorporated in the country.
2. All the countries concerned tax the income of national source in the case of individuals or legal entities domiciled or incorporated abroad; among them, Mexico also taxes the

income obtained by Mexicans wherever the income may be obtained.

3. There are five countries (Colombia, Chile, Honduras, Mexico, and Peru) that basically apply the world-wide income principle to taxpayers (legal entities and individuals) domiciled or resident in the country (in other words, to these taxpayers they apply in addition to the source principle the domicile principle); on the other hand, Mexico applies additionally the nationality principle and taxes Mexican taxpayers domiciled abroad within certain limits. As a general rule, Mexico follows the principle of the source of payment as a criterion to establish the Mexican source of income.

   There are two countries (Brazil and El Salvador) that apply the world-wide income criteria only in respect of individual taxpayers domiciled in the country.

4. All the previously mentioned seven countries that apply the world-wide income criteria, except Honduras, have regulations for taking the tax paid abroad as a credit against the tax to be paid in the country and there is also one country — Mexico — which accepts the credit of the tax exempted abroad (tax sparing) except in the case of capital gains tax.

5. The remaining 11 countries basically apply the source principle or territoriality and some special circumstances can be noted:

   (a) Uruguay only taxes income of individuals when derived from industrial, commercial or similar activities, whilst Paraguay does not tax, in general, income from personal or professional services even if they are dependent services, or agricultural income.

   (b) Some countries (Argentina, Bolivia, the Dominican Republic and Guatemala for instance) tax occasional profits obtained abroad by persons domiciled in the country.

   (c) Some countries (Argentina, Bolivia, the Dominican Republic, Honduras and Nicaragua, for instance) regulate or limit the concept of foreign source in the case of imports, with the purpose of protecting the tax interests of the country.

   (d) Various countries (Argentina, Bolivia, Colombia, Ecuador, Honduras, Costa Rica, Guatemala, Uruguay and Peru, for instance) consider as national source income payments for technical assistance provided from abroad (principle of payments source).

   (e) Some countries (Bolivia, Costa Rica, Mexico, Paraguay and Peru, for instance) consider as national-source income compensation paid to members of Boards of Directors resident abroad, and in the case of Bolivia, also interest paid to persons domiciled abroad.

   (f) In the case of Ecuador, income obtained in the country by persons who have stayed less than six months in the country is not considered to be of national source and if they have stayed between six months and one year only 80 percent of the income is considered of Ecuadorian source. In addition, the income obtained by foreigners domiciled in Ecuador in respect of compensation paid from abroad by foreign bodies or enterprises is considered to be income of Ecuadorian source.

   (g) Panama adheres to a strict concept of income that is limited or restricted in certain special cases.

   (h) In practice all the countries concerned exempt the income obtained in the country by foreign diplomats derived from the exercise of their official function. In the majority of the cases reciprocity is required.

   (i) In order to determine income of national source of agencies and branches of foreign enterprises, Argentina, Bolivia, Chile, Guatemala, Paraguay and Uruguay, for instance, require the maintenance of separate accounting records.

   (j) The concept of "permanent establishment" is applied to enterprises domiciled abroad, in the case of Chile and Ecuador, for instance.

Regarding this particular matter, one must remember that the member countries of the Cartagena Agreement, commonly known as the Andean Pact (at present: Bolivia, Colombia, Ecuador, Peru and Venezuela) approved, in 1971, Decision No. 40, under which Model Conventions to avoid double taxation on income and wealth taxes were approved, among the member countries and in relation to countries outside the Region.

The Agreement has been ratified by all the member countries and became fully effective as from January 1, 1979.

The Agreement admits, as a general principle, taxation at source, which has been covered in Article 4 as follows: "Independent of the nationality or domicile of persons, income of any nature obtained by them will only be taxed in the member country in which such income has its productive source, except in the exceptional cases foreseen in this Agreement."

In the following provisions the concept of productive source is determined for different types of income and certain exceptions are made under which persons domiciled in a member country are not taxed on:

- income derived from the rendering of personal services or from the exercise of professional activities and technical assistance in other Contracting States of the Andean Pact;
- income such as dividends, interest, royalties and rentals from other Contracting States of the Andean Pact.

In the same way, it is established that transport enterprises of one Contracting State are not subject in any other Contracting State.

As regards taxation criteria, it must be pointed out that in the Latin American area ample doctrine has been produced by the Latin American Tax Institute and by the group of experts of the Latin American Association of Free Trade (ALALC). In both cases, the prevailing tendency has been to claim the right to apply the jurisdictional criterion of the territorial source as taxation criterion, which fits more with the reality of international business and with the sovereignty principle. In this respect, the member countries of ALALC (Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay and Venezuela) have agreed at the expert level and as a recommendation, on a set of provisions or guides to orient the eventual negotiation of tax treaties among the member countries and among them and other countries. The recommendation, which is not yet obligatory and has not been approved officially by the Governments of member countries, follows substantially the rules established in the Andean Pact Models, containing, however, certain innovations in order to make the application of the source principle more flexible.

### B.3. Conclusions concerning deductible expenses

As a general rule, all the pertinent legislation admits the deduction of expenses incurred, duly supported, necessary to produce or to maintain the source. There are, however, certain provisions which are worthwhile to cite in relation to expenses incurred abroad and to certain types of remittances abroad which are as follows:

1. It is deemed that expenses incurred abroad are made for the

production of income of foreign source (Argentina, Bolivia, Brazil, the Dominican Republic and Peru), but this assumption is not absolute and admits proof to the contrary. In all the other cases, deduction of such expenses is allowed, as a general rule, if they fulfill the general principle of "necessity" and the quantitative limits established in certain legislations (for example, Colombia, El Salvador, Paraguay and Peru).

2. Expenses for royalties and technological transfers are deductible if they fulfill the various express requisites in the case of Argentina, Brazil, Guatemala and Mexico. The payment of royalties from branches to the head office is not allowed by Brazil. There is wide scope for the payment of these items in the case of Bolivia, Chile, Costa Rica, Honduras, Nicaragua, Panama, Uruguay and Venezuela.

As regards deductible expenses, it may be added as a matter of interest that the member countries of the Cartagena Agreement (Bolivia, Colombia, Ecuador, Peru and Venezuela) approved in 1970 Decision No. 24 which establishes a common regime for the treatment of foreign capital and for trademarks, patents, licenses and royalties, determining, inter alia, that:

> "*Article 2* — All foreign investors that want to invest in any of the Contracting States have to file an application before the competent national body, which, based on a prior evaluation, will authorize it if it complies with the priorities of development of the recipient country. The application must observe guidelines contained in Annex 1 of the regime. The Commission, at the request of the 'Junta', can approve common criteria for the evaluation of foreign investment in the member countries.
>
> . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . .
>
> *Article 5* — All direct foreign investment will be registered with the competent national body together with the Agreement determining the conditions of the authorization. The amount of the investment will be registered in freely convertible currency.
>
> . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . .
>
> *Article 14* — External loans require prior authorization from the competent body and must be registered with them.
>
> Global limits of external borrowing may be authorized for specific periods. Loan contracts within such global limits must be registered before the competent body.
>
> . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . .
>
> *Article 16* — Remittances by enterprises in payment of the principal and interest of external credit, will be authorized based on the terms of the registered contract.
>
> In the case of contracts for external credit between subsidiaries and their parent or with other subsidiaries, the effective annual rate of interest cannot exceed by more than three points the rate of interest effective for blue chip securities in the financial market of the country of origin of the currency in which the transaction has been registered. For contracts for external credit other than those already mentioned, the effective rate of interest payable by enterprises will be determined by the competent national body, the rate having to be closely related with the rate prevailing in the financial market of the country where the financing has been obtained.
>
> For the purposes of this Article, the effective interest will be the total cost payable by the debtor for the utilization of the loan, including commissions and any kind of expenses.
>
> . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . .
>
> *Article 18* — All contracts for import of technology and for patents or trademarks must be examined and submitted for the approval of the competent body of the respective member country, which body must evaluate the effective contribution of the imported technology by estimating the probable profits, the price of the goods incorporating such technology and other specific methods for quantifying the effects of the imported technology.
>
> . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . .
>
> *Article 21* — Intangible technological contributions give the right to the payment of royalties, if previously authorized by the competent national body, but they cannot be contributed as capital.
>
> When these contributions are provided to the enterprise by its parent or by other subsidiaries of the same parent, payments of royalties will not be authorized and deduction for tax purposes will not be allowed.
>
> . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . .
>
> *Article 45* — The capital of corporations must be represented by nominative shares.
>
> The bearer shares existing at present shall be converted into nominative shares within a term of one year as from when this regime becomes effective."

## C. CONCLUSIONS CONCERNING THE TREATMENT OF INCOME DERIVED FROM INTERNATIONAL ACTIVITIES

The great majority of Latin American countries have established express provisions to determine the taxable income of enterprises domiciled or incorporated abroad and carrying out activities in each national territory. The well known cases are transport and communication enterprises, news agencies, insurance and reinsurance companies, and companies exhibiting or distributing cinematographic films and the like.

As mentioned when referring to the binding criteria, the great majority of the countries apply the tax on income of national source in the case of taxpayers domiciled abroad. In the case of enterprises devoted to international activities as those already mentioned, formulae have been established in each country to determine first the income of national source and then income subject to tax. Table No. 5 has been prepared on this basis, giving rise to the following conclusions:

1. As regards transport enterprises and as may be seen from the summary in Table No. 6, there are six countries in which the taxable income can be determined on the basis of percentages of gross income from transportation between the country and another (however, in Uruguay and the Dominican Republic there is the option of proving the effective income). There are four countries where taxable income may be determined on the basis of percentages of operations or sales within the country and there are two countries which allow taxable income to be determined on the basis of percentages of operations between countries (notwithstanding, Panama gives the option to determine the income on an effective basis). Finally, five countries authorize other formulae (basically on the basis of a proportion of world-wide income to local income).

2. In the case of insurance, in practice all the countries take as national-source income the revenue from transactions covering risks in the country, while in various countries a percentage of the income of national source is taken as taxable income.

3. In the case of international news agencies and the exhibiting and distributing of films, the gross amount received by the beneficiaries is taken as income of national source and the taxable income is fixed, also as a general rule, by applying percentages on such income (between 15 and 80 percent depending on the country).

**TABLE NO. 1**
**Latin American countries and the type of tax applied**

| Country | Type: Global | Type: Schedular | Observations |
|---|---|---|---|
| Argentina | x | | |
| Bolivia | x | | |
| Brazil | x | | |
| Chile | x | x | |
| Colombia | x | | |
| Costa Rica | x | | |
| Dominican Rep. | x | x | |
| Ecuador | x | x | |
| El Salvador | x | | |
| Guatemala | x | | |
| Honduras | x | | |
| Mexico | x | | |
| Nicaragua | x | | |
| Panama | x | | |
| Paraguay | x | | (Individual and agricultural income are, in general, not taxed) |
| Peru | x | | |
| Uruguay | | | (Individual income is not taxed; there is a tax only on industrial and commercial activities and special taxes on agricultural activities and others) |
| Venezuela | x | | |

**TABLE NO. 2**
**Income tax rates applicable to companies incorporated in the country**

| Country | Flat rate (%) | Progressive rates (%) | |
|---|---|---|---|
| | | Maximum | Minimum |
| Argentina | 33 | | |
| Bolivia | 30 | | |
| Brazil | 35 | | |
| Chile | 50 | | |
| Colombia | 40 | | |
| Costa Rica | | 45 | 5 |
| Dominican Rep. | | 38 | 10 |
| Ecuador | 20 | | |
| El Salvador | | 15 | 2.5 |
| Guatemala | | 48 | 5 |
| Honduras | | 40 | 3 |
| Mexico | | 42 | 5 |
| Nicaragua | | 50 | 6 |
| Panama | | 50 | 20 |
| Paraguay | | 30 | 25 |
| Peru | | 55 | 20 |
| Uruguay | 25 | | |
| Venezuela | | 50 | 18 |

**TABLE NO. 3**
**Tax on dividends and on profits remitted to head office or beneficiaries domiciled abroad**

| Country | Withholding Tax (%) | Type: Final | Type: Provisional | Observations |
|---|---|---|---|---|
| Argentina | 17.50 | x | | |
| Bolivia | 30 | x | | |
| Brazil | 25 | x | | 15 percent if profits are reinvested in industrial equipment. |
| Chile | Non-existent | | | Companies or subsidiaries in the country are taxed at the rate of 40 percent; in addition to the 1st category of 10 percent and the 5 percent dwelling tax. |
| Colombia | 20 | | x | 40 percent in certain cases and also a supplementary tax of 12 or 20 percent as a general rule. |
| Costa Rica | 15 | x | | A credit is granted for the tax paid abroad. |
| Dominican Rep. | 18 | x | | |
| Ecuador | 40 | x | | |
| El Salvador | 28 | x | | |
| Guatemala | 10 | x | | |
| Honduras | 15 | x | | |
| Mexico | 21 | x | | |
| Nicaragua | Non-existent | | | Profits of corporations only are taxed. |
| Panama | 10 | x | | |
| Paraguay | 30 | x | | 40 percent in the case of legal entities. |
| Peru | 40 | x | | 30 percent in certain cases. |
| Uruguay | Non-existent | | | Dividends are exempted. Profits distributed by a branch or agency are subject to a 20 percent final tax. |
| Venezuela | 20 | x | | |

## TABLE NO. 4
**Comparative summary of binding criteria applied by Latin American countries**

| *Countries* | *Individuals domiciled in the country* | *Legal entities incorporated in the country* |
|---|---|---|
| Argentina | S | S |
| Bolivia | S | S |
| Brazil | D | S |
| Chile | D | D |
| Colombia | D | D |
| Costa Rica | S | S |
| Dominican Rep. | S | S |
| Ecuador | S | S |
| El Salvador | D | S |
| Guatemala | S | S |
| Honduras | D | D |
| Mexico | D-N | D |
| Nicaragua | S | S |
| Panama | S | S |
| Paraguay | S | S |
| Peru | D | D |
| Uruguay | S | S |
| Venezuela | S | S |

*Codes:*
S = Source criterion or territoriality
D = Domicile criterion
N = Nationality criterion



## TABLE NO. 5
**Determination of the source of income taxable in the case of companies engaged in international transport and communications, insurance, news, exhibiting and distributing films, not incorporated or domiciled in the country**

*Notes:* SI (Determination of national-source income)
TI (Determination of taxable income)

| *Country* | | *Transport and communications* | *Insurance* | *International news agencies* | *Exhibiting and distributing films* |
|---|---|---|---|---|---|
| Argentina | SI | Gross amounts between Argentina and abroad. Absolute presumption. | Gross income on transactions covering risks in the country. Absolute presumption. | Gross income received. Absolute presumption. | Price paid. Absolute presumption. |
| | TI | 10% of SI (15% in the case of containers) | Effective income with deduction of expenses. | 10% of SI | 50% of SI |
| Bolivia | SI | Gross amounts between Bolivia and abroad. Absolute presumption. | Gross income on transactions covering risks in the country. Absolute presumption. | Gross income received Absolute presumption. | Price paid. Absolute presumption. |
| | TI | 2% of SI | 2% of SI | 2% of SI | 15% of SI |
| Brazil | SI | Gross income of Brazilian source. | | | |
| | TI | 20% or option of determination on an effective basis. | | | |

*Notes:* SI (Determination of national-source income)
TI (Determination of taxable income)

| *Country* | | *Transport and communications* | *Insurance* | *International news agencies* | *Exhibiting and distributing films* |
|---|---|---|---|---|---|
| Colombia | SI | Proportion of effective income considering relationship between national gross receipts and world-wide receipts. | | | Price paid. |
| | TI | SI less expenses | | | 60% of SI |
| Costa Rica | | Administrative resolutions considering a percentage of world-wide income. | | | |
| Dominican Rep. | SI | Income between the Dominican Rep. and the other country | Income on transactions covering risks in the country | | Gross income received. |
| | TI | Option between 10% of SI or effective income | Option between 10% of SI or effective income | | 15% of SI |
| Ecuador | SI | Total proceeds of sales in the country through permanent establishments | Effective profit or based on coefficients provided by the tax administration | | Effective profit in the country through permanent establishment |
| | TI | 2% of SI | | | |
| El Salvador | SI | Proportion of world-wide income based on gross receipts | Idem | Idem | Idem |
| | TI | SI less expenses | SI less expenses | SI less expenses | SI less expenses |
| Guatemala | SI | Gross amounts between Guatemala and abroad. | Income on transactions covering risks in the country | | Gross income received |
| | TI | 10% of SI | | | 80% of SI |
| Honduras | SI | Proceeds from sales in the country | Income on transactions covering risks in the country | Gross income | Gross income received |
| | TI | 20% of SI | 10% of SI | | |
| Mexico | SI | Proportion between local and world-wide profits | | | |
| Nicaragua | SI | Income in the country | Income on transactions covering risks in the country | | Gross income received |
| | TI | Between 5 and 10% of SI | Between 2 and 10% according to the type of insurance | | 30% of SI |
| Panama | SI | Gross income between Panama and the other country and vice versa | Effective income on transactions covering risks in the country | | Gross income received |
| | TI | Option between 10% of SI or effective income | Effective income (re-insurances are exempted) | | 15, 50 or 75% of SI depending on the case |

Notes: SI (Determination of national-source income)
TI (Determination of taxable income)

| Country | | Transport and communications | Insurance | International news agencies | Exhibiting and distributing films |
|---|---|---|---|---|---|
| Paraguay | SI | Income on contracts in the country | Income on transactions covering risks in the country | | Gross income received |
| | TI | 10% of SI | 10% of SI (8% on re-insurance) | | 60% of SI |
| Peru | SI | Income between Peru and the other country | | Gross income received | Gross income received |
| | TI | Between 1 and 5% of SI, depending on the case | | 10% of SI | 20% of SI |
| Uruguay | SI | Income on transactions between Uruguay and the other country | Income on transactions covering risks in the country | Gross income received | Gross income received |
| | TI | Option between 10% of SI or effective income | Option between 2 and 10% of SI per type of insurance or effective income | Option between 10% of SI or effective income | Option between 30% of SI or effective income |
| Venezuela | SI | 50% of gross receipts between Venezuela and abroad and vice versa | Income on transactions covering risks in the country | Gross income received | Gross income received |
| | TI | 10% of SI | 30% of SI | 15% of SI | 25% of SI |

## TABLE NO. 6
## Summary of the application of income tax on international transport enterprises

| Country | Taxable income determined (percentage) | | | Effective taxable income of national source | Others |
|---|---|---|---|---|---|
| | From the country to abroad | From the country to abroad and vice versa | From sales in the country | | |
| Argentina | 10 | | | | |
| Bolivia | 2 | | | | |
| Brazil | | | | 20 | |
| Colombia | | | | | x |
| Costa Rica | | | | | x |
| Dominican Rep. | 10 | | | | |
| Ecuador | | | 2 | | |
| El Salvador | | | | | x |
| Guatemala | 10 | | | | |
| Honduras | | | 20 | | |
| Mexico | | | | | x |
| Nicaragua | | | 5 to 10 | | |
| Panama | | 10 | | | |
| Paraguay | | | 10 | | |
| Peru | 1 to 5 | | | | |
| Uruguay | 10 | | | | |
| Venzuela | | 5 | | | |

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# ISRAEL:
# The Gabbay Report

**A proposal for inflation-adjusted taxation of income in Israel**

By Dr. J.F. Pick

The dilemma of choosing between accuracy and practicability continually accompanies the discussion about tax adjustments for inflation.

A comprehensive inflation adjustment of the taxable income in any of its possible versions may be theoretically the best solution for taking inflation into account in the collection of income tax in high inflation countries. But those trying to work out a good system of such adjustment and to put it into practice will soon become aware of the difficulties involved. Because of these difficulties the majority of countries which have decided to make some adjustment for inflation in their income tax system have restricted themselves first of all to relatively simple ad hoc measures, in most cases in the field of inventory relief or accelerated depreciation. These measures almost always grant relief which is not in proportion to the loss suffered from inflation because the loss depends also on the way of financing; except for some South American countries, tax relief for effects of inflation has not been accompanied by a "monetary adjustment", i.e. an allowance for the loss of the creditor and the gain of the debtor from inflation. That so-called monetary adjustment appears to be the most important element in a system of full inflation adjustment.

The committee of exports appointed by the Israeli Minister of Finance in August 1979 (when the annual rate of inflation in Israel approached 100 percent) to recommend methods for solving the taxation problems connected with inflation and especially those concerning:

(a) the real value of depreciation allowances for tax purposes
(b) the impact of inflation on inventories in the different economic branches; and
(c) the treatment of the effect of inflation on the own funds of the business;

proposed in its report submitted to the Minister of Finance in March 1980 to go the hard way of full inflation adjustment. It expressed the view that Israel has reached a rate of inflation which demands such adjustment, among other reasons, because the distortions which partial adjustments for inflation by way of ad hoc measures would create are acceptable only at much lower rates of inflation.

The report of the committee refers expressly to the incentive to invest in real assets and the encouragement to work with borrowed capital which are inherent in a tax system based on nominal value and which adversely affect the economic system.

The main point in the proposal of the GABBAY Committee, named after its chairman *Joseph Gabbay*, the deputy director of inland revenue, is the creation of a "capital maintenance reserve" deductible from taxable income.

The amount to be transferred to the maintenance reserve has to be calculated once a year and is composed of five elements:

(1) The main element is an extended monetary adjustment. It consists of the adjustment by the rate of inflation of the current year on the net sum of "erosible assets" at the beginning of the year. "Erosible assets" is the surplus of monetary claims with the addition of inventories, most machinery and some securities over monetary liabilities. The report explains in detail the inclusion of machinery in that item. Because of the high allowance given under this method in the first two years — a full inflation adjustment for the cost of machinery in addition to depreciation at historical cost — the total tax allowance is granted more quickly than by an adjustment of the annual depreciation allowance; although over the life time of the machinery almost the same allowance — in real terms — is granted.

(2) The second element is an adjustment of depreciation on "non-erosible" assets, especially factory and hotel buildings. That adjustment is in addition to historical cost depreciation based on the rise of the cost of living index from the time the building was acquired or erected until the end of the current year of business. The "non-erosible" assets group also includes securities not traded on a stock exchange, patents, prepaid expenses, loans granted and tax payments. However, buildings seem to be the main item in this group calling for an adjustment of depreciation.

(3) The "erosible assets" group includes securities traded on the Tel Aviv stock exchange. The third element in the calculation of the transfer to the capital maintenance reserve is the deduction from that transfer of the sum of book profits and realised profits on those traded securities. Profits on traded securities are tax free and the deduction of these profits is necessary for reasons of symmetry because the inclusion of traded securities in the non-erosible assets group would otherwise give holders of such securities twofold tax relief, by way of deduction of the profits from those securities from the taxable income and by an allowance, within the capital maintenance reserve, for the loss of value of the amount invested in traded securities.

(4) The calculation of the first element on the basis of the position at the beginning of the business year would in many cases result in a distortion of the amount transferred to the capital maintenance reserve unless there is an adjustment for changes in the amount of capital employed and in the composition of assets during the year. Therefore, the fourth element contains an adjustment for changes during the year, among them the inflow of new share capital, distribution of cash dividends, the acquisition or erection of buildings, the purchase of patent rights or non-traded shares or the sale of "non-erosible assets".

(5) By an adjustment for the effects of inflation on the value at the end of the year of the "real profits" of the

year the fourth element is somehow supplemented. Just as monetary assets available at the start of the business year lose value in the course of the year, profits made at the beginning of the year lose at almost the same rate. The fifth element of adjustment is an allowance for the effect of inflation on the profits made during the year. That adjustment amounts to 20 percent of the "real profits" of the year multiplied by the rise of the index. The calculation is based on the assumption that the profit is made gradually during the year (arriving at 50 percent); tax at a rate of 60 percent is deducted from 50 percent of the profit. A negative "real profit" is not taken into account in the calculation of the transfer to the capital maintenance reserve.

In the view of the authors of the report the transfer from profit to the capital maintenance reserve achieves fairly correctly the aim of a changeover from nominal to real profits.

In case the transfer as calculated by summing up the five elements arrives at a negative balance the authors propose the deduction of that balance from the finance costs allowed for tax purposes. In case the negative balance exceeds the amount of finance costs the excess should be deducted from the (tax free) inflationary element of a capital gain made during the same year or from the transfer to the capital maintenance reserve of a related enterprise or should be set off against past losses. Negative balances which cannot be used for one of the above mentioned purposes have to be carried forward to the next year and will be considered a monetary liability in the calculation of next year's transfer to the capital maintenance reserve.

Except for industrial enterprises, the committee proposes the calculation of the capital maintenance reserve on the basis of only 90 percent of the rise of the cost of living index or that part of the rise which exceeds 10 percent (the lower of the two).

Somehow in contrast to the exact method of calculating the transfer to the capital maintenance reserve, the committee proposes a further device for reducing the cost of inflation adjustment by restricting the transfer to the capital maintenance reserve to 50 percent of the profit subject to tax before that transfer. Any excess over that 50 percent has to be carried forward of the following year as an "erosible asset".

Regarding the application of the new system, the committee suggests its introduction for a limited period of three years.

The system should be compulsory for all taxpayers who must then keep a complete set of books of account on accrual basis, with special regulations for taxpayers reporting on cash basis.

The calculation of the capital maintenance reserve by corporate bodies has to be examined by auditors.

The report deals to some extent also with specific problems of certain economic branches, e.g. livestock in agriculture and the stock of land held by building contractors. Going into these details would exceed the framework of this report. But it appears important to mention that the report refers to the specific problems of inflation adjustment in the tax accounts of financial institutions. Dealing with these problems has been entrusted to a subcommittee which has not yet submitted its report.

Although in Israel a few hundred industrial companies with foreign participation are already entitled to submit an inflation adjusted tax calculation on the basis of the RONAL Amendment (Amendment 15 to the Law for the Encouragement of Capital Investment) of March 1977, the proposal of the GABBAY committee is the most far-reaching plan prepared in Israel, and probably one of the most far-reaching plans anywhere, for an adjustment of tax accounts for inflations. The system appears logical and comprehensive and though various details may require change or improvement, the proposals form a complete and symmetric entity. The members of the committee deserve much credit for their work.

The GABBAY proposals aim to move as far as possible from the taxation of nominal profits to the taxation of real profits. In fact, the tax account model worked out in the proposals is based on historical cost accounts adjusted for general price level changes.

Inflation adjustment as such would not require a changeover of accounting methods to current costs but without it accounts do not show real values. The relationship between price level adjusted accounts based on historical cost and accounts based on replacement cost or current values depends on the different trends of price changes for different materials and goods and also on technological changes.

The GABBAY committee rightly restricted itself to price level changes. It would appear almost impossible to achieve a changeover to current cost accounting for the large number of small and medium sized enterprises in Israel. Even if achievable, such an adjustment may be considered unnecessary within an inflation adjustment of the income liable to tax.

In December 1979 the Institute of Public Accountants in Israel adopted Opinion 23 requiring all firms the turnover of which exceeded in 1979 IL 300 million and all companies the shares or bonds of which are traded at the Tel Aviv Stock Exchange to add to the notes to their financial statements from 1980 onward a statement on the effect of inflation on the profit and loss account. That statement on the effect of inflation calculates those effects on the basis of general price level changes and in the main on a general concept similar to that of the proposals of the GABBAY committee but there are many differences of detail. It would appear that in case the GABBAY proposals are to be put into effect a harmonisation of the accounting principles between financial accounts and inflation adjusted tax accounts would be of great assistance.

There appear to be three main problems involved in the decision concerning a possible implementation of the proposals:

(1) *the administrative difficulties;*

(2) *the restriction of the tax advantage presently enjoyed by certain economic branches, mainly manufacturing;*

(3) *the choice of the methods for restricting the effect of inflation adjustments on total tax collection.*

(1) An examination of the proposals from the point of view of their administrative implementation is bound to reveal the most difficult problem. It would require a large degree of imagination to envisage the adjustment of all changes during the year (element 4) — in capital employed and in the distribution between "erosible" and "non-erosible" assets — of the large number of small and medium sized firms or companies covered by the proposal.

Even the RONAL Amendment, which was tailored for a few hundred companies only, provides for an easier method of calculating the transfer to the capital maintenance reserve than the GABBAY proposals which are intended for application to some hundred thousand taxpayers.

It would appear that similar to the RONAL adjustment method the calculation of the transfer to the capital maintenance reserve should be based on only two elements — the adjustment of the effect of inflation on the balance of erosible assets at the beginning of the year and the adjustment of depreciation on the non-erosible assets. Even such an adjustment would strain to the hilt the professional manpower in the tax administration and in the economy.

Some adjustments for changes during the year may be kept in reserve as a right of the tax administration to ask for more details and to demand adjustments for such changes in cases of execessive tax planning or special circumstances. The adjustment of the real profit becomes less important if the adjustment for changes during the year is dispensed with and traded securities may be transferred to the "non-erosible assets" group if only for the sake of saving administrative work.

(2) During most of the period of the existence of the State of Israel special tax advantages and other incentives have been granted to certain economic branches, mainly to manufacturing industries. These incentives have been part of a policy aiming to achieve economic independence by fostering industrial exports. Though the aim has not been fully achieved because of the great security requirements of Israel, the substantial increase of industrial exports can certainly to some extent be ascribed to these incentives.

The GABBAY report proposes on the whole a neutral application of the new measures retaining only very slight advantages for industry by adjusting for 100 percent (instead of 90 percent) of the rise of the index and by treating machinery as "erosible assets" which has a certain pro-industry bias. Against that, the accelerated depreciation and the inventory relief granted in the tax years 1978 to 1980 which gave manufacturing industry considerable tax incentives are to be abolished.

While the move towards more "neutrality" in tax laws would in principle be a highly desirable development, legislators would have to ask themselves whether a reduction of incentives to industry would hamper the achievement of the goal of increasing industrial exports.

(3) The letter of appointment of the committee by the Minister of Finance of 14 August 1979 aked the members to take into account the "fiscal limitations" which would affect the implementation of their recommendations. Out of these considerations the committee proposed:

(a) *to adjust "erosible assets" for 90 percent only of the rise of the index;*
(b) *to deduct any negative balance of the equity maintenance allowance from finance expenses allowed for tax purposes;*
(c) *to restrict the transfer to the capital maintenance reserve in any year to 50 percent of the taxable profit before that allowance.*

(a) The restriction of the adjustment to the excess of the rate of inflation over 10 percent seems the most reasonable of these measures. Taxpayers in other countries with inflation at an annual rate of around 10 percent also suffer taxation of inflationary profits at that rate.
Furthermore, if full tax relief for the effect of inflation cannot be granted, an equal proportional reduction of the relief to all taxpayers appears the most appropriate way for reducing the cost to government.

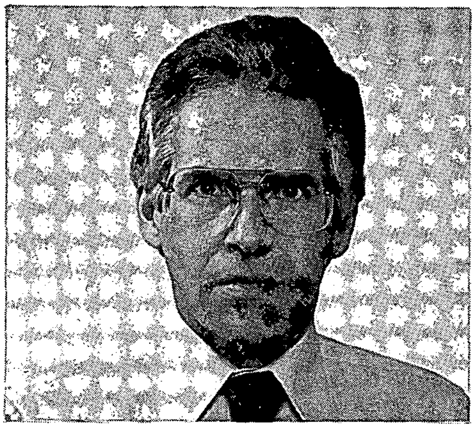
(b) The deduction of a negative capital maintenance reserve balance from finance expenses appears reasonable and logical because such negative balance represents generally a debtor's gain from the decline of the value of his debts in times of inflation.
There may be certain problems related to the proposed treatment of that item. Because long term credit in Israel is extremely restricted the main cases of a negative capital maintenance reserve (an excess of monetary liabilities over the sum of monetary assets, inventories and machinery) are probably manufacturers and hotels which financed their buildings with direct credits which they obtained as an incentive for increasing exports (including tourist trade treated as export). These enterprises will now be charged with the full debtor's gain on their long term debt, i.e. its decline in value due to inflation while in respect of the building acquired with that loan they will obtain tax relief by way of an adjustment of the amount of depreciation at a much slower pace. The GABBAY report explains that this disadvantage is in fact taking away an advantage that until now existed in these cases because the enterprises concerned can presently write off linking differences on their loans currently as they accrue and more quickly than the loans are repaid, thus resulting in a certain tax deferment. Nevertheless, their suggestion that the above problem should be solved in the field of financing and not by fiscal methods may be difficult to achieve. It would appear that the disadvantage of an immediate full charge for the debtor's gain as against the very gradual adjustment of depreciation of the assets financed by those debts should be partly cured by a certain tax deferment. Otherwise the inflation adjusted tax system would, in view of the financing problems prevailing under conditions of high-rate inflation, create an anti-investment bias which may be as harmful as the present pro-investment bias referred to in the GABBAY

report which, however, in recent years did not prove strong enough to maintain productive investment at the desired level.

(c) The restriction of the transfer to the capital maintenance reserve to 50 percent of the taxable profits before that transfer appears to be the main flaw in the GABBAY committee proposals. It is surprising that such an unbalanced and regressive adjustment device found its way into the report which in most of its other parts is highly consistent and careful to maintain maximum symmetry. If the annual rate of inflation amounts to 80 percent an enterprise earning 200 percent on its own funds would, under the 50 percent rule, pay tax only on its very substantial real profit but no tax on its nominal inflationary profit. Another enterprise which earned only 50 percent on its own funds, which at that rate of inflation means a real loss, would nevertheless have to bear tax on 50 percent of its unreal profit. In that way the restriction of the transfer of the capital maintenance reserve to 50 percent of the profit before that transfer would hit hardest taxpayers with real losses or with relatively small real profits, while those with high real profits remain unaffected.

From all points of view it would appear preferable to achieve a reduction of the tax relief granted by way of an equal abatement of the relief granted instead of applying the regressive 50 percent rule which hits hardest those taxpayers with real losses.

If the proposal can be changed in the directions here indicated the GABBAY report could form the basis for an experiment in inflation-adjusted taxation of income which should be studied with interest also outside the State of Israel.



# Nathan Boidman:*

# INTERPRETATION OF TAX TREATIES IN CANADA

## A. AN OVERVIEW OF THE PROBLEMS OF INTERPRETATION

*One might expect to glean profound wisdom from the following comments on treaty interpretation because they are based on an extensive review of most reported income tax treaty cases in Canada to date and a fair number of cases in other countries.* [1] *Presumably, they reflect a coherent body of interpretative principles, developed and applied on a consistently evolving basis, and providing, therefore, sound guidelines as to the manner in which we might expect a treaty to be interpreted and applied and as to how treaty cases will be dcided in the future. However, there are two reasons why one may well be disappointed if such are one's expectations.*

**AUTHOR'S NOTE**

*This Article is an edited version of the text of a paper presented to the International Fiscal Association, U.S.A. Branch, at its Fourth Annual Meeting in Philadelphia, 17 - 18 January 1980, on "New Developments In Tax Treaties". The paper focuses on the manner in which Canadian Courts interpret tax treaty cases, seeking to identify the extent, if any, to which there is a consistent and/or coherent body of rules of interpretation, with comparative comment respecting the approach of the judiciary in other countries, particularly the U.S. The underlying research was carried out for purposes of a book on treaty interpretation in Canada, scheduled to be published by the Canadian Tax Foundation.*

### 1. The mix between domestic and international rules

First, Courts often tend to interpret treaties in much the same manner as they would domestic tax statutes, only hesitantly bringing into play rules which are particularly apt for a treaty issue. The result is an unpredictable mix between the use of purely domestic rules of interpretation in some cases and a blend of domestic and treaty rules in other cases, making it difficult to foresee the resolution of a future treaty issue.

The problem is accentuated by the predilection of Courts to conscientiously propound the need to adopt broader rules of interpretation while in fact failing to wrest themselves from the more restrictive framework in which domestic tax issues are resolved.

The basic principle of treaty interpretation in Canada was stated by the Tax Appeal Board in *Saunders* v. *M.N.R.*:

> *"The accepted principle is to be that a taxing act must be construed either against the Crown or the person sought to be charged, with perfect strictness, so far as the intention of Parliament is discoverable. Where a tax Convention is involved, however, the situation is different and the liberal interpretation is usual in the interest of the comity of nations. Tax Conventions are negotiated primarily to remedy a subject's tax position by the avoidance of double taxation rather than to make it more burdensome. This fact is indicated in the preamble to the Convention. Accordingly, it is undesirable to look beyond the four corners of the Convention and Protocol in seeking to ascertain the exact meaning of a particular phrase or word therein."* [2,3]

On the other hand, Mr. Justice Cattenach in the Federal Court, Trial Division wrote in *Stickel* v. *Her Majesty The Queen*:

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1. This research was carried out for purposes of a book on treaty interpretation in Canada, scheduled to be published by the Canadian Tax Foundation. It reflects court decisions to Janaury 15, 1980.
to January 15, 1980.
2. 54 DC 524, at 526.
3. This statement of judicial policy has been referred to in several subsequent decisions, such as, *Canadian Pacific Limited* v. *Her Majesty the Queen* 76 DTC 6120, *Vauban Productions* v. *Her Majesty The Queen*, 75 DTC 5371 and *Shahmoon* v. *M.N.R.* 75 DTC 275.

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*"The consensus of all writers is that treaties are to be construed in the most liberal spirit provided, however, that the sense is not wrested from its plain and obvious meaning.*

*In my view, the duty of the Court is to construe a treaty as it would construe any other instrument public or private, that is, to ascertain the true intent and meaning of the contracting States collected from the nature of the subject matter and from the words employed by them in their context. In this I am assisted by the preamble of this particular Treaty which states that two of the overall aims are the avoidance of double taxation and the prevention of fiscal evasion in the case of income tax."* [4]

It is seen that Mr. Justice Cattenach would substantially restrict the object of liberal interpretation of treaties by conventional rules of interpretation, and his decision in *Stickel* [5] could fairly be considered to be within the constraints of domestic revenue law interpretation.

## 2. Inconsistency of application

Secondly, there is the old domestic problem of inconsistency of selection or application of conflicting or competing rules or methods of interpretation. This problem is a recurring theme in this paper (see, in particular, section B).

As one cynic (so self described), an eminent international tax lawyer who will grace our podium at this meeting, said in a letter to me, commenting on the first draft of my book: [6]

> "I have completed reading your Treatise on interpreting Canada's income tax treaties and feel that you are undertaking an impossible task. I am quite cynical about the Court's analysis. I believe that in most cases, the Courts decide an answer to the problem and then adopt the appropriate rationale."

### (a) The U.S. experience in treaty abuse cases

Perhaps our cynic had in mind the difficulty of reconciling some of the more renowned U.S. treaty cases: the decisions in *Perry Bass* v. *C.I.R.*, [7] on the one hand, and as a group those in *Compagnie Financière de Suez et de l'Union Parisienne* v. *U.S.*, [8] *Johansson et al* v. *U.S.* [9] and *Aiken Industries Inc.* v. *C.I.R.* [10] The latter cases suggest that the U.S. Courts are quite prepared to disregard a taxpayer's compliance with formalism and adherence to specific requirements of a treaty exemption or to seek out defects in documentation or formal inadequacy in order to give effect to an overriding principle that a treaty should be interpreted such as to assure its prime purpose of avoiding double taxation and the converse thereof, that it not be interpreted so as to allow the avoidance of all taxation (or taxes in more than one country) or what can be preceived as an undue, abusive or unintended avoidance of taxes which might otherwise become due. On the other hand, *Perry Bass* [11] can reasonably be regarded as standing for the proposition that attention to detail, formal adequacy or observation of the legal niceties can provide success in a treaty case regardless of the rupture of the underlying purposes of double tax agreements. As you well know, in *Perry Bass* [12] the taxpayer effectively reduced his overall tax burden by interposing a Swiss corporation between himself and various investments in the United States, succeeding on the basis of the "viability" principle, that is, the company looked and acted like a real corporation having been very carefully adorned with all

4. 72 DTC 6178, at 6182, 3.
5. Supra note 4, reversed by the Supreme Court of Canada, 74 DTC 6268.
6. Supra note 1.
7. 50 T.C. 595.
8. 492 F. 2d 798; or 74-1 USTC, 83505.
9. 336 F. 2d 809; or 64-2 USTC 93907.
10. 56 T.C. 925.
11. Supra note 7.
12. Supra note 7.

the accoutrements of an ongoing enterprise. The Court was of the view that it ought to disregard "the personal purpose of a taxpayer in creating a corporation", provided that substantive business functions are carried out. Compare, however, *Johansson* [13] and *Suez.* [14]

In *Johansson*, [15] the Court, in holding the taxpayer's scheme to be untenable, stated:

> "*The primary objective of our Treaty with Switzerland, as well as those with more than 20 other countries, is the elimination of the impediments to international commerce resulting from the double taxation of international transactions.*" [16]

The Court went on to find that the attempt by Johansson to shelter the prize money he would earn from his heavyweight championship boxing match with Floyd Patterson by utilizing a Swiss company should not succeed for the reason, inter alia, that such tax relief was not necessary for the purpose of eliminating impediments to international commerce.

> "*Scanart, S.A. had no legitimate business purpose but was a device which was used by Ingemar Johansson as a controlled depository and conduit by which he attempted to divert, temporarily, his personal income, earned in the United States, so as to exempt taxation thereon by the United States.*" [17]

The Court rejected strict or mechanical interpretation and cited *Maximov* v. *U.S.*: [18]

> "*In determining whether the taxpayer in a given case is protected by the terms of a treaty, abstract and desultory definitions of such terms as 'residence' and 'legitimate business purposes' are of limited, if any, assistance. 'To give the strict word of the treaty a meaning consistent with a genuine shared expectation of the contracting parties, it is necessary to examine not only the language but the entire context of the agreement.'*" [19]

Then, dealing with the proper locus of taxation in relation to the purpose and operation of a double tax agreement:

> "*Thus, as a general rule, the income from services is taxable when the services are rendered . . . Where, as here, services are performed in the United States, and the compensation for them is drawn from the wealth of the United States, this is the country of primary economic impact and consequently, the appropriate taxing locus. There are, however, a number of potential exceptions in the general 'economic impact' rules. Among them is a view that a business enterprise engaged in international commerce ought not to be subject to taxation in every country in which he may transact some business. Although such an enterprise does draw upon the wealth of the various countries with which he comes into contact, the overall objective of encouraging international commerce, as well as the practical necessities of business planning are better satisfied by a centralized regime of taxation at the enterprise's business seat or permanent establishment. The business seat exception is found in Article III of the Swiss Treaty. Elements of this exception are also found in Article X. Typical of what have become known as "commercial traveller provisions" in the international tax conventions, the Article is designed to assure business establishments in each of the contracting States that they may freely send their agents and employees into the other Contracting State without thereby subjecting those employees to the latter's taxes. Like Article III, it is an exception to the 'economic impact' rule, carved out in the interest of facilitating international trade. Where the practical reasons for the exception do not obtain, however, the general rule must apply. Thus, while Johansson may have brought himself within the words of the Swiss Treaty by his 'residence' in Switzerland and his 'employment by a Swiss enterprise', he has failed to establish any substantial reasons for deviating from the treaty's basic rule that the income from services is taxable where the services are rendered. International trade will not be seriously encumbered by a refusal to grant special tax treatment to one only marginally if at all Swiss resident and only technically if at all employed by a paper Swiss corporation.*" [20]

In *Suez* [21] the Court expressed its views on the proper and improper use of treaty provisions in the following words:

> "*Ultimately this case also turns on the intent and purpose of the Convention as agreed upon by the signatories. The purpose and intention of the tax Convention between the U.S. and France was to avoid double taxation and to alleviate the problems arising from it. The parties, to a bilateral agreement, are 'primarily' concerned with removing an obstacle to a flow of trade and investment between the two countries. . . . The fact is that the plaintiff is not confronted with the problem of double or burdensome taxation that the Treaty is designed to alleviate or eliminate. There is no double tax on the income of the plaintiff since it is not taxed in France. There is no obstacle to trade or commercial intercourse in the context of this case.*" [22]

The Court dealt with "unintended" treaty benefits:

> "*We cannot read the Treaty to accord unintended benefits inconsistent with its words and not compellingly indicated by its invocation. Our interpretation affords every benefit negotiated for by the parties to the Convention on behalf of their respective residents and prevents an intended tax default to a private party.*" [23]

The Court also considered the issue in terms of allocation of jurisdiction to levy tax:

> "*The plaintiff claims based on the Treaty that an adverse decision would violate the rules of comity. This is not so because the only tax authority involved*

13. Supra note 9.
14. Supra note 8.
15. Supra note 9.
16. Supra note 9, at 93910.
17. Supra note 9, at 93909, 10.
18. Infra note 46.
19. Supra note 9, at 93910.
20. Supra note 9, at 93910.
21. Supra note 8.
22. Supra note 8, at 83514, 5.
23. Supra note 8, at 83515.

*is that of the United States. If the United States surrendered its authority in accordance with the plaintiff's claim, it would gain nothing for which it negotiated under this Treaty. Also, France has no interest in this matter because its authority to tax is not in dispute. France disclaimed its right to tax the income in dispute. United States' interests and benefits are the only ones involved relative to the Convention, therefore a result unacceptable to the plaintiff, either based on the Convention or indirectly structured to it, an unfavorable choice of law in no way violates the principle of comity. The decision merely protects the principle of the Convention, avoidance of double taxation."* [24]

## B. The problem of inductive versus deductive processes of interpretation and broadly stated canons of interpretation

I encountered two particularly thorny problems in trying to identify a coherent theory and underlying body of rules of interpretation for tax statutes and treaties, problems which are probably inherent in any legal analysis.

### 1. Inductive v. deductive analysis

Tax Courts tend to vacillate between, on the one hand, the desire to methodically apply in a purley deductive manner prevailing principles and rules of interpretation and, on the other hand, the tendency to inductively (or perhaps intuitively) draw conclusions from a maze of available data (the facts, the law and the rules of interpretation and application), hopefully factoring in the deductive analysis required.

The latter approach appears to be a natural response to the difficulties raised in tax avoidance cases, such as the U.S. cases noted earlier where the judicial concern is to avoid decisions which ignore or overlook underlying purposes of the relevant statute or treaty.

It is my own view that the inductive approach gives rise to inconsistency and incompleteness of reasoning and that the problem is accentuated by broadly worded canons or dicta of interpretation (more on the latter below).

#### (a) The deductive approach

The deductive approach should involve a two-step process:

- First, the transaction at issue should be characterized or qualified as to its true or substantive nature for tax assessment purposes–
- Then, the relevant law or statute can be applied or interpreted in relation thereto.

#### (i) Characterizing or qualifying the transaction

The first issue is whether we are dealing with a transaction which is carried out without regard to tax law, including treaties; or is it one which was structured with tax law in mind, for example, *Johansson*;[25] or, is it one which had no purpose other than to yield a tax benefit,[26] such as *Aiken*,[27] where an existing debt relationship between a Bahamian and U.S. corporation was restructured to obtain advantage of the then existing Honduras-U.S. Treaty.

In the first category we simply have the question of applying or interpreting the treaty provision in relation to the factual situation. In the second category we must make an initial determination (before interpreting or applying the treaty provision) of the true substance or commercial effect of the particular transaction, overall, bringing into play doctrines of step transaction, substance over form, etc. In the third category the question of categorization and qualification of the transaction becomes all important with the ultimate sanction that the transaction will be ignored in its entirety on the basis of sham or lack of business purpose, or that the alleged taxpayer is a mere agent, as was the reasoning in *Aiken.*[28]

The point is, that the interpretative process is one-dimensional in the first type of situation and multi-dimensional in the second and third categories.

If there is a failure to recognize the necessity of first qualififying the true substance of a transaction, the objective of consistent interpretation (particularly where there are competing, alternative rules of interpretation) may be compromised. For example in Canada, as I will comment on in more detail below, there still remains an uncertainty as to whether a revenue statute should be interpreted strictly (literally) or broadly bringing into play the intent of the legislator and other (extraneous) factors.[29] Such a determination should not be made by reference to the particular nuance or circumstances surrounding the issue at hand; however, where the Court has failed to first deal specifically with the question of categorization, it may tend to use an interpretation rule based not on a consistent policy within that country or Court in relation to the particular law under consideration, but, rather, one which provides a desirable or equitable result in the particular case. For example, if it is common ground that a treaty provision is to be interpreted contextually a Court should not apply a strict or literal reading simply because the result thereof would accord more with the apparent policy or purpose of the

24. Supra note 8, at 83515.
25. Supra note 9.
26. These three different types of transactions or issues are referred to below as "categories".
27. Supra note 10.
28. Supra note 10.
29. In the 1930s, the United States abandoned the strict rule of interpretation, in *White* v. *U.S.*; (1938) 305 U.S., 281 and adopted the "business purpose test" in *v. Helvering* v. *Gregory*, 60 F. 2d 809, aff'd (1935), 293 U.S. 465 and *Wellard* v. *Commissioner*. The doctrines of "agency" and "sham" can be seen in *Barthel* v. *Birmingham*, 332 U.S. 126 (1947, 1847-2 C.B. 174); *Ringling Brothers, Barnum & Bailey* v. *Higgins*, 189 F. 2d 864 (2nd Circuit) 1950; *Filipidis* v. *United States*, 71-1 U.S. c. 85 828 (M.D.) 1970 (confirmed); Curin, 71-2 U.S. T.C. 87 830 (4th Circuit 1970) 14; *Richard Rubin*, 56 T.C. 1155, 1159-60 (1970), affirmed 46 DF 2D 1216 (2nd Circuit) 1972; *Moline Properties Inc.* v. *Commissioner*, 319 U.S. 436, 438-439 (1943), 1943 C.B. 1011; *Floyd Patterson* T.C. 1966-329, affirmed 1968 - 2 U.S. T.C. 87, 623 (2nd Circuit 1968).

particular treaty provision. Rather, the task of negating matters such as a lack of business purpose in a transaction should be left to the initial characterization process; the animus of the transaction should not influence or compromise consistent and logical selection and application of rules of interpretation.

Treaty cases in Canada have yet to involve the second and third category situations. The main reason is that until 1976 there was no difference between treaty rates and domestic rates on most forms of passive investment withholding tax levies, being perhaps the area most prone to abusive planning. In addition, for whatever reason, perhaps lack of detection, issue has not been made of situations where certain treaty countries have been utilized as a base for carrying on business in Canada without permanent establishments, claiming business profit treaty exemption in circumstances where the substantive aspect of the activity was foreign to the base (treaty) country used.

There is a tendency, of course, for modern treaties to contain specific anti-abuse provisions which effectively codify or formalize what I perceive as the first process otherwise necessary in a treaty issue determination. For example, under Article XXVII (2) of the yet to be ratified, renegotiated, Canada-United Kingdom Treaty:

> "*Where under any provision of this Convention any person is relieved from tax in a Contracting State on certain income and, under the law in force in the other Contracting State, that person is subject to tax in that other State in respect of that income by reference to the amount thereof which is remitted to or received in that other State, the relief from tax to be allowed under this Convention in the first-mentioned State shall apply only to the amounts so remitted or received.*"

This, of course, is meant to deal with non-domiciled U.K. residents who can avoid U.K. tax on unremitted foreign source income.

### (ii) Applying principles or rules of tax treaty interpretation

Once the transaction has been characterized (as well as applying or perhaps ignoring the principle enunciated in *Suez* [30] and *Johansson* [31] that a treaty cannot be simply utilized at the discretion of a taxpayer) consideration can then be given to what I prefer to consider the true or strict questions of interpreting tax treaties. The following is a brief summary of how Canadian and some other Courts have used the possible principles or rules of interpretation.

#### (A) *A treaty should not expand the ambit of taxation*

In Canada the dicta in *Saunders* [32] cited above have been construed to extend or expand the liability for tax which would arise in the absence of the treaty. I believe this is a fairly universal rule with the exception of France, where a treaty can apparently serve to increase the ambit of taxation (Article 4 bis-2, 165 bis and 209 G.C.I.). Another possible exception to this rule may be discerned in a decision under the Germany-Luxembourg Treaty referred to in the *International Tax Treaty Service* [33] at page 11 of the section on Article XIV.

#### (B) *Eliminating double taxation*

Hopefully a treaty is to be interpreted in light of the purpose of avoiding double tax. This is the third of the three schools of tax treaty interpretation identified by Fitzmaurice: the "aims and objects" school.[34]

However the majority of cases indicates that this rule of interpretation is usually subordinated to the first two schools of interpretation identified by Fitzmaurice: the "Founding Fathers School" or the "Ordinary Meaning of the Words School".[35]

Cases where the purposes of treaties have been manifestly observed include *Appleby* v. *M.N.R.*,[36] *Reeder* v. *M.N.R.*[37] [38] On the other hand, there are far more cases where the basic purposes of treaties are not determinative in the decisions: *Stickel* v. *M.N.R.*,[39] *Fletcher* v. *M.N.R.*,[40] *A.G. Munich (Jr.)* v. *M.N.R.*,[41] *C.J. Crawford* v. *M.N.R.*,[42] *Furness Pacific Ltd.* v. *M.N.R.*,[43] *Joe Snell* v. *M.N.R.*,[44] *A.P. Hilton* v. *M.N.R.*,[45] *Maximov* v. *U.S.*,[46] *Mathewson* v. *M.N.R.*,[47] *Hurd* v. *M.N.R.*[48]

Lord Donovan of the House of Lords in *Imperial Chemical Industries Ltd.* v. *Caro*[49] expressed this rule this way:

> "*It is true that this may produce an anomaly... but in this particular appeal which deals with different*

30. Supra note 8.
31. Supra note 9.
32. Supra note 3.
33. Michael Edwardes-Ker, *The International Tax Treaties Service*, In-Depth Publishing Ltd., Dublin, 1978. Another example is the 1979 decision of the Privy Council in *Hock Heng Co. (1979)* STC 291 as reported in *The International Tax Strategy Service*, In-Depth Publishing Ltd., Dublin, 1978, in 1979 Bulletin No. 5, page 7. The Council rejected an attempt by the Malaysian tax authorities to deny a deduction to a Malaysian company for losses of a Singapore branch, as is permitted under Malaysian domestic tax law, on the basis that the treaty between Malaysia and Singapore would have exempted the Malaysian company from tax on such profits and therefore losses therefrom should be denied. A finding to this effect would have permitted a treaty to expand the ambit of taxation and the decision is therefore consistent with the general rule noted.
34. As summarized by David Ward in *Principles To Be Applied In Interpreting Tax Treaties* (1977) 25 Can. Tax. J., 263.
35. The first school is also referred to as the "intentions of the parties school", the second school as the "textual" school and the third as the "teleological" school. Fitzmaurice's first school can also be thought of as the liberal or contextual approach while the second school is closer to the strict or literal approach dealt with below. It would seem that the "aims and objects" school plays an important role only in abuse of treaty cases such as the four U.S. cases dealt with earlier.
36. 79 DTC 172.
37. 75 DTC 17.
38. See also, the Internal Revenue Services' interpretation of *The Estate of Tait* v. *The Commissioner*, 11 T.C. 731.
39. Supra notes 4 and 5.
40. 77 DTC 185.
41. 51 DTC 115.
42. 51 DTC 99.
43. 52 DTC 1048.
44. 68 DTC 745.
45. 63 DTC 336.
46. 2. Cir., 1962 299 F. 2d 565, aff'd. 373 U.S. 49 (1968).
47. 63 DTC 490.
48. 79 DTC 5369.
49. 39 T.C. 374 (CA).

*taxes levied in different countries on different lines, protection in any system of double taxation relief must almost be impossible to achieve."*

Lord Upjohn said:

*"It very frequently happens, owing to the complexity of modern taxation, that anomalies and hardship do arise. There is only one safeguard, and that is, to give effect to the plain meaning of the words which Parliament has thought fit to use."*[50]

(C) *Counteracting tax evasion or avoidance*

Should a treaty be interpreted in light of the purpose of combating tax evasion or avoidance? This certainly seems to be the view of the U.S. Courts in *Burbank*[51] where the exchange of information article of the U.S.-Canada Convention was given broad application in respect to co-operation between the taxing authorities, in contrast to many European, particularly Swiss, decisions.

(D) *Achieving reciprocity of taxation*

Should a treaty be interpreted in light of the purpose of providing reciprocity of taxation between the two taxing jurisdictions? This principle, in part, underlay the dicision in *Johansson:*

"*The primary objective of our Treaty with Switzerland, as well as those with more than 20 other countries, is the elimination of the impediments to international commerce resulting from the double taxation of international transactions.* The basic mechanism of these treaty arrangements is the establishment of standards for determining the single most appropriate locus of the taxation of any given transaction. *Although some treaty provisions are inevitably the result of political compromise, the dominant criterion for determining the appropriate taxing locus is economic impact" (emphasis added).*[52]

A similar objective can also be seen as underlying the permanent establishment and enterprise cases under the U.S.-Canada Convention, in *Rutenberg* v. *M.N.R.*,[53] *Abed* v. *M.N.R.*,[54] *Consolidated Premium Iron Ores Ltd.* v. *Commissioner of Internal Revenue*,[55] *Number 473* v. *M.N.R.*,[56] *McMahon* v. *M.N.R.*,[57] *Number 630* v. *M.N.R.*,[58] *Donroy Ltd.* v. *U.S.*,[59] and *Johnston* v. *C.I.R.*,[60] all referred to below.

(E) *Avoiding abuse of treaties*

Should a treaty be interpreted so as to prevent it from being a means of avoiding tax? This idea was dealt with in the opening portion of the paper, being an issue which has come up before the U.S. Courts but not yet before the Canadian Courts.

(F) *The use of extrinsic aids*

In interpreting treaties may reference be had to extrinsic aids? Canada has traditionally been more conservative in this area than, I believe, the U.S. The basic rule in Canada is that "travaux préparatoires" and legislative history of a statute are not admissible as evidence in the interpretation of a statute *(Attorney General of Canada* v. *Readers Digest Association).*[61] I understand the contrary rule was adopted in 1896 in the *United States* v. *Freight Association.*[62] Perhaps Article XXXII of the *Vienna Convention on Treaties*, 1969, which advocates the admissibility of "travaux préparatoires", will eventually be followed by Courts in Canada. Similarly, it remains to be seen whether commentaries on the OECD Model would be referred to by a Canadian Court, as was the procedure adopted by the U.S. Court in *Burbank.*[63]

(G) *Interpretation as a contract*

The question of interpreting a treaty as a contract and not as a statute is considered separately below with particular reference to the propriety of unilateral acts of interpretation by administrative officials and the effect thereof before the Courts.

(H) *The influence of international law*

What is the influence of rules of international law, relations and concepts on the interpretation of treaty cases? As seen above, the Canadian Courts generally refer to the desirability of more liberal interpretations in a treaty issue. Consideration is given elsewhere to the

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50. In a recent New Zealand case, D1 (1979 4 NZ TC, Taxation Review Authority, February 19, 1979) as reported in *International Tax Strategy 1979*, Bulletin No. 3, page 14, a U.S. citizen, retired in New Zealand, failed in his attempt to invoke the New Zealand-U.S. Income Tax Treaty to avoid paying New Zealand tax on pension benefits under the U.S. Social Security Program. The gist of the taxpayer's argument was that Article 18 should be construed to avoid double taxation, being the result, in a sense, of the pension having been derived from contributions which had been made on a non-deductible basis. Article 18 provided as follows:
*"When a person shows proof that the action of the revenue authorities of the Contracting Governments has resulted or may result in double taxation in his case in respect of any of the taxes to which the present Convention relates, he shall be impelled to lodge a claim with the Government of which he is a citizen or in whose territory he is resident. If the claim should be deemed worthy of consideration, the taxation authorities of such Government may consult with the taxation authorities of the other Government to determine whether the double taxation in question may be avoided."*
In rejecting this argument, the court said:
*"There is no mandatory provision that double taxation must be avoided. The terms of the Agreement are permissive only and confer no absolute right on a taxpayer to insist that such consultation be held. In equity, however, I have no doubt that in appropriate cases proper consultation would be had between the revenue authorities of the two countries."*
51. 36. AFTR 2D 75, 6227, Cert. denied, 96 S.CT 2647 (1976).
52. Supra note 9, at 93910.
53. 79 DTC 5394.
54. 78 DTC 6007.
55. Court of Appeals, 6th Circuit, reported, inter alia 59 DTC 1112; See also, 57 DTC 1146 for the decision of the Tax Court.
56. 57 DTC 300.
57. 59 DTC 1109.
58. 59 DTC 300.
59. 301 F 2d 200.
60. (1955) T.C. 920.
61. 61 DTC 1273.
62. (1896) 166 USR, 290.
63. Supra note 51.

OECD Model and commentaries and the Vienna Convention on treaties. In a Rhodesian case,[64] the Chief Justice, Beadle, spoke of "an international language" requiring wide and broad interpretation in order that the purposes of tax treaties be achieved. The Federal Court of Canada in *Canadian Pacific* [65] was prepared to accept an administrative interpretation (of the U.S. Treasury) to achieve avoidance of the double tax while the Tax Review Board in *Number 630* [66] referred to the persuasive influence of the U.S. decision in *Johnston* [67] in deciding a permanent establishment case under the U.S.-Canada Convention. These instances of the Canadian Courts looking to foreign decisions augur well for an international approach to treaty interpretation in Canada. In the U.S. the reliance in *Burbank*[68] on the OECD commentary is an important breakthrough in internationalizing the interpretation of treaty issues.[69 70]

(I) *The question of strict v. liberal interpretation*

This is considered separately below.

### (b) The inductive approach

There are times when the deductive approach considered above is short circuited and fused into what I have labelled the inductive approach in the sense that either the transaction is not fully characterized or qualified, as a first step, or consideration is not given to the full range of rules or principles of interpretation.

Ideally, the Court should consider the full range of interpretative principles which may be relevant to applying a treaty provision and apply them consistently within a reasonable overall theory of treaty, as opposed to domestic tax statute, interpretation.

### 2. The problem of broadly stated canons or dicta of interpretation

Uncertainty sometimes is created by broadly worded canons or dicta of interpretation: Consider the words of Domoulin, J. in *Western Electric Company Inc.* v. *M.N.R.*

> "*... dealing, as I must, with a measure of exception, expressly enacted by the contracting parties to limit the extent of their own national laws and to devise special rules governing special cases of mutual interest, I feel bound to adhere closely to the current and ordinary meaning of the Treaty terms, ever more so than to provisions of any other statute.*" [71]

Is this in the spirit of the broad rule of interpretation advocated in *Saunders*,[72] or does it suggest a restrictive approach to granting alleviation under tax treaties. It would appear that either view is possible, the former on the basis that the second part of the statement is merely reformulation of the statement in *Saunders* that:

> "*Accordingly, it is undesirable to look beyond the four corners of the Convention and Protocol when seeking to ascertain the exact meaning of a particular phrase or word therein.*"

The latter view can be argued on the basis that the first part of the statement contemplates that the extent to which the contracting parties intend to limit the extent of their own national laws is to be narrowly construed.

The point is that the Courts as well as the legislator or treaty negotiator should speak as clearly and unambiguously as possible.

## C. THE PROBLEM OF STRICT VERSUS LIBERAL INTERPRETATION

### 1. Overview: Canada v. U.S.

It is important to point out that my observations of the Canadian experience in treaty interpretation are probably not too helpful a guide to treaty interpretation in the United States. This is because of the substantial difference between the two countries in basic domestic revenue statute interpretation. As far back as 1938 the United States rejected the concept of strict or literal interpretation of revenue statutes adopting the liberal or contextual intent of the legislator doctrine (see *White* v. *U.S.* [73] ).

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64. Aktiebolaget Tetra Pak, Appellante Division, (1966) S.A. 198. Reported at page 17 under Article VII of the *International Tax Treaties Service*, supra.
65. *Canadian Pacific Limited* v. *The Queen*, 76 DTC 6120, Walsh, J. at page 6135: *"While it is true that this Court has the right to interpret the U.K.-Canada Tax Convention and Protocol itself and is in no way bound by the interpretation given it by the United States Treasury, the result would be unfortunate if it were interpreted differently in the two countries when this would lead to double taxation. Unless, therefore, it can be concluded that the interpretation given in the United States is manifestly erroneous it is not desirable to reach a different conclusion and I find no compelling reason for doing so."*
66. Supra note 58.
67. Supra note 60.
68. Supra note 51.
69. Canadian Courts have rarely relied specifically on international instrumentalities or rules of interpretation in treaty cases although the underlying interpretative process often is the same. For example, the reasoning in *Tara Exploration and Company Limited* v. *M.N.R.* 72 DTC 6288 respecting the meaning to be given "permanent establishment" (see below) and the commentary to Article IV of the OECD Model Treaty which advocates that the objective is to determine a "degree of permanence" in the activity carries on and to this end "factors should be examined first, singly and then as a whole, and whether examined in the latter fashion or in the former fashion, the ultimate test of permanency is to be kept in mind as well as the related criteria of whether the activities carried on are of a profit making nature or are, instead, of an auxiliary or preparatory nature."
70. See also the recent development in *Hunter Douglas* v. *The Queen* 79 DTC 5340 where reference is made to the Vienna Convention on the Law of Treaties. In the 1979 decision in *Fothergill* v. *Monarch Airlines Ltd.* (1979) 3 WLR 491 (C.A.), the English Court of Appeal in a case involving an international convention on law respecting carriage by air objected to the use of "travaux préparatoires" with a strong dissent by Lord Denning. However, the influence of an international approach was seen in the decision of the Supreme Court of the Netherlands, BNB 1979/116, March 14, 1979 (as reported in *International Tax Strategy 1979* Bulletin No. 6, page 10) which involved references to the Commentary of the OECD 1977 Model and decisions in other European countries.
71. 79 DTC 5204, at 5210.
72. Supra note 2.
73. Supra note 29.

In *Helvering* v. *Gregory*,[74] Judge L. Hand advocated that the Court should be given discretion to, in effect, round out the law as it would in a decision or issue involving a private contract.

Such an approach more readily accommodates the more progressive rules of interpreting treaties described above.

For example, in *London Display Company NV* v *U.S.*,[75] a case under the Netherlands Antilles-U.S. Tax Treaty, the Court had little difficulty in deciding that the provision in the Treaty dealing with industrial and commercial profits should prevail over the provision dealing with the leasing of artistic works in relation to a contract of lease, in respect of wax figures, by a company specializing in provision of display materials and props to a U.S. enterprise to be used in commercial display.[76]

## 2. The Canadian situation

On the other hand, in Canada, we have yet to resolve in a definitive fashion the conflict between strict and liberal interpretation in revenue statutes generally. This notwithstanding that section 11 of the *Interpretation Act of Canada* which governs the manner in which all Canadian statutes are to be interpreted specifically provides for liberal interpretation:

> *"Every enactment shall be deemed remedial and shall be given such fair, large and liberal construction and interpretation as best insures the attainment of its object."* [77]

For example, the Supreme Court of Canada in *Stickel* [78] held that a visiting American professor was eligible for an exemption under Article VIII A on earnings derived from teaching on a temporary basis in Canada notwithstanding that the Court had noted that the taxpayer had, in all probability, not paid any tax in the U.S. and thereby would benefit unduly from the decision by avoiding all tax. However, because Mr. Stickel came within the four corners of the exemption, his application was upheld.

That the Supreme Court of Canada came to its decision by reference to the words of the Convention, strictly construed, rather than perhaps its manifest purpose, may be demonstrated as follows:

> *"I am not overlooking the fact that the respondent paid no tax in the United States on the income in question here. There is evidence that the United States tax authority has treated him as a non-resident in respect to this income. Although the evidence is scanty, I am prepared to infer that this might have been the result of some representation made by the respondent to the United States tax authority. Our problem is whether he comes within the treaty giving him exception from Canadian tax on his Canadian income and on this issue I agree with the Federal Court of Appeal that he does and on both grounds given by the Courts."* [79]

The decision of the Federal Court, Trial Division in 1979 in *British Columbia Railway Co.* v. *The Queen* [80] is a recent illustration of strict interpretation. In that case a federal sales tax was held to have no effect because of absence of certainty as to when the tax was to be levied.

The problem is particularly acute in cases of relatively clear, unambiguous statutory language (more on this below).

Often the result is that Canadian judges, conditioned by such an ambiguous and ambivalent approach to domestic tax cases, bring a mixed bat of strict versus liberal interpretation to treaty cases. This is so notwithstanding the expressed preference for "liberal" interpretation in treaty cases (see *Saunders*, etc. supra).

The underlying conflict is further complicated by a real dichotomy in the manner in which the strict versus liberal principle is applied in cases of clear statutory language as opposed to ambiguous, unclear provisions. In the latter circumstances the approach has tended to be more towards that adopted in the U.S. since the 1930s, with the Courts tending to accept the responsibility of seeking out the legislative intent;[81] accordingly, in treaty cases involving ambiguous or conflicting provisions there is a better chance that the decision will be grounded in a suitable application of relevant underlying rules of interpretation.

The problem is substantial in the former category (that is, situations of apparently straightforward and clear statutory language) where the Canadian Courts in treaty

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74. Supra note 29.
75. 46 T.C. 511.
76. The principle of liberal interpretation in tax treaty cases in the U.S. was stated as follows by the Supreme Court of the United States in *Geofroy* v. *Riggs* (1890 133 U.S. 642 at 646):
*"It is a general principle of construction with respect to treaties that they should be liberally construed so as to carry out the apparent intention of the parties to secure equality and reciprocity between them. As they are contracts between independent nations, in their construction words are to be taken in their ordinary meaning, as understood in the public law of nations and not in any artificial or special sense impressed upon them by local law, unless such restricted sense is clearly intended. And it has been held by this court that where a treaty admits of two constructions, one restrictive of the rights which may be claimed under it and the other favourable to them, the latter is to be preferred."*
77. The theory of literal or strict interpretation in Canada sprang from a famous U.K. decision in the 19th century, *Partington* v. *The Attorney General* (1869) LR HL 100, at page 122; *"As I understand the principle of all fiscal legislation it is this: If the person sought to be taxed comes within the letter of the law he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be. In other words, if there be admissible in any statute, what is called an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute."*
78. Supra note 6.
79. Supra note 6, at 6269.
80. 79 DTC 5020.
81. However, as recently as last year, in a domestic case, the Federal Court, Trial Division, in *Harmon* v. *M.N.R.* 79 DTC 5037, chose, in the case of an ambiguous statutory provision, to rely on a strict rule of construction, namely, that an ambiguity in a taxing provision is to be construed against the tax collector.

as well as domestic cases show a propensity to interpreting on a liberal or strict application of the words regardless of the apparent conflict with interpretations which would be derived from a balanced application of the overall body of interpretation suitable for double tax treaties.

## 3. Examples of strict interpretation

As noted in *Stickel*,[82] Article VIII A of the U.S.-Canada Treaty was at issue and the Supreme Court of Canada found that its terms clearly required only that the purpose and intention at the time of coming into Canada be to stay for only two years in a teaching capacity. Provided this requirement could be considered factually to have been met the professor was entitled to the exemption regardless of actual subsequent events and, as noted, regardless of other ancillary considerations such as taxation in the U.S.

The 1977 decision of the Tax Review Board in *Sydney S. Fletcher* v. *M.N.R.*[83] is a good, recent example of the strict interpretation in treaty manners. The startling aspect in this case is that the Canadian taxpayer was able to claim reduction of Canadian tax by invoking a provision of the U.K.-Canada Treaty (Article IX, dealing with dividends paid by a Canadian company) which one would have thought was available only for the benefit of residents of the U.K. The language of Article IX, literally construed, had direct application to the Canadian taxpayer but only, apparently, as an anomalous result.

For examples of strict interpretation in the U.K. see *Nothman* v. *Cooper*[84] and *Oppenheimer* v. *Cattermole*.[85]

In the United States the U.S. Supreme Court decision in *Maximov*[86] may also be considered to be of a restrictive type. In that case, a U.K. resident did not qualify for the exemption granted under the U.S.-U.K. Treaty with respect to capital gains derived in the U.S. by a U.K. resident for the reason that the interest of the U.K. resident was held in a trust, the trustees of which were resident in the U.S. with the capital gains being accumulated. The reasoning was that the scheme of the Internal Revenue Code was to treat a trust as a separate person and that the claim by the taxpayer was "too remote" and would require an unwarranted rewriting or refashioning of the provisions of the domestic U.S. law in order to grant the exemption. This would seem to sacrifice the objects of a tax treaty to formalities of domestic law construction.[87]

## 4. Examples of liberal interpretation

In contrast to these examples of strict interpretation is a recent decision of the Tax Treaty Board of Canada in *Appleby* v. *M.N.R.*[88] where the language of the U.K.-Canada Treaty was liberally stretched in order to grant relief against an apparant case of double tax as between the payer and the recipient of alimony payments.

*Tara Exploration and Company Limited* v. *M.N.R.*[89] and *Consolidated Premium Ores Ltd.*[90] are good examples of contextual-liberal interpretations in Canada and the U.S., respectively, in the case of the rather clear words of a treaty. In each case, the taxpayer corporation had maintained a relatively inactive, norminal office in another country, did not carry on any substantial business activities in or as a result of that office and was held not to have a permanent establishment, notwithstanding the plain words of the treaty involved. *Tara* involved the Canada-Ireland Treaty and *Consolidated Premium* the Canada-U.S. Income Tax Convention. In both cases the Courts decided that the intent clearly was to identify as "permanent establishments" places where real and continuous business activities were carried out. In *Tara* the Supreme Court of Canada stated:

> *"Although the respondent maintained a bank account in Toronto, most decisions with regard to the writing of cheques on this account emanated from the president of the respondent who was resident and domiciled in Ireland at all material times. An employee of the respondent's accountant in Toronto, in charge of accounts payable, had authority to co-sign cheques without obtaining approval from Ireland for routine administrative accounts. On such occasions, approval was obtained from the respondent's solicitor in Toronto, who in turn obtained the requisite approvals from Ireland. I doubt whether the office in Toronto was a "permanent establishment" within the definition of that term contained in the Treaty. It seems to have been little more than an office maintained to enable the respondent to comply with the requirements of the Corporations' Act."*[91]

In *Consolidated Premium* the Sixth Circuit Court approved the judgement of Judge Van Fossan of the Tax Court of the United States which included the following passage:

> *"Premium had no real office in the United States; no officers, directors or employees here; no bank account or books of account; no telephone listing; its name did not appear on any door or office; it had no employee or agent established here who had 'general authority to contract for the employer or principal', such authorization being one of the definitive tests of a 'permanent establishment' under the Treaty.*
>
> *The term 'permanent establishment' and the term 'engaged in trade or business' both imply a place for*

82. Supra notes 4 and 6.
83. 77 DTC 185.
84. (1975) 1 All E.R. 538.
85. 50 T.C. 159.
86. Supra note 46.
87. *Hunter Douglas Ltd.* v. *The Queen*, supra note 70, where a Canadian company which had moved its central management to the Netherlands was held to be exempt from Canadian withholding tax on dividend payments made by it to shareholders in various countries, pursuant to the specific language of Article IV(5), is another decision of the strict interpretation variety. Clearly, there can be some doubt as to whether such third country shareholders, in the circumstances of the case, were intended to benefit from the Netherlands-Canada Treaty.
88. 79 DTC 172.
89. 72 DTC 6288, supra note 69.
90. Supra note 55.
91. Supra note 69, at 6290.

*carrying on a trade or business in the United States. Although the two terms are not synonymous, both relate to the same concept and apply the same general conditions . . . . Respondent contends, in effect, that the procuring of a license from the State of Ohio and the printing of a letterhead with the same address as Otis and Company, coupled with certain isolated acts of Eaton and Aly, demonstrated that the petitioner had a 'permanent establishment' in the United States. The fact is that the petitioner made returns to the State of Ohio each year, stating that it had not done ultimately, surrendered the license. It is also clear that there was no agent or officer at such address authorized to do business for the petitioner: . . . the term 'permanent establishment' normally interpreted suggests something more substantial than a license, a letterhead and isolated activities. It implies the existence of an office, staffed and capable of carrying on the day to day business of a corporation and its use for such purpose or it suggests the existence of a plant or facilities equipped to carry on the ordinary routine of such business activity. The descriptive word 'permanent' in the characterization 'permanent establishment' is vital in analyzing the treaty provisions. It is the antithesis of temporary or tentative, it indicates permanence and stability."* [92] [93]

There will be times where departures from strict interpretation are justified by the so called "golden rule of interpretation", comprising the concept that departure from literal interpretation is justified in circumstances where the results of the latter would be manifestly absurd and occasionally on the wider grounds of the "intention" of Parliament. (See for example, *Home Oil Company Ltd.* v. *M.N.R.*,[94] *Allied Farm Equipment Ltd.* v. *M.N.R.*[95] and *Sunbeam Corporation (Canada) Ltd.* v. *M.N.R.*[96] ). There really is no basis to predict which of these obviously conflicting rules of interpretation will be invoked by the Canadian Courts, either in a domestic or treaty context — leaving the predictability of results highly uncertain.

## D. THE QUEST FOR CLEAR TREATY PROVISIONS - AND SOME COMMENTS ON THE BUSINESS PROFIT EXEMPTION ARTICLE IN TREATIES

### 1. General considerations

The inherent difficulty in tax treaty interpretation was aptly expressed as follows by D.P. O'Connell:

*"It is said that where a treaty clause is clear and unambiguous it is not required to be interpreted. However, it may be doubted if a clear and unambiguous cause has ever been divised."*[97]

I think what he was saying is simply that no particular sentence or article in a tax treaty can alone import to the reader all that is required in determining whether or the manner in which it will apply to a particular transaction.[98] And I say this in really two respects. First, I have in mind the problem of categorization or qualifying of a transaction of the category two or three type I referred to above, that is, where all formal requirements of the particular treaty exemption sought have been complied with, but where the overall substance of the matter is that the taxpayer was not intended to benefit from the treaty, considered from an intuitive approach. Secondly, I have in mind the issues which will arise when due weight is given to each particular word of a seemingly straightforward provision. Consider, for example, Article 1 of the Canada-U.S. Convention which reads as follows.

*"An enterprise of one of the contracting States is not subject to taxation by the other contracting State in respect of its industrial and commercial profits except in respect of such profits allocable in accordance with the Articles of this Convention to its permanent establishment in the latter State."*

### 2. Problems of interpreting Article I of the U.S.-Canada Convention

Certainly the concept, purpose and generally intended operation of Article I are straightforward. However, just about each word gives rise to definitional problems which cause much uncertainty as to the overall applicability. We are all used to the question of when does a permanent establishment exist and the excellent judgments on that issue in cases such as *Consolidated Premium*[99] and *Tara.*[100]

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92. Supra note 55, at 1161, 2.
93. A decision of the Lower Court of Amsterdam (No. 1106/76 M11) June 20, 1978, as reported in *International Tax Strategy 1979*, Bulletin No. 9, page 7 is a good example of a decision consistent with *Consolidated Premium* and *Tara*. The substance of the arrangement was an ongoing permanent representation and precense of a Swiss company in the Netherlands which was held to be a permanent establishment notwithstanding that the arrangement apparently skirted the strict language of the treaty. In other words, the real substance of the arrangements in relation to the basic purpose of the treaty provision prevailed.
94. 55 DTC 1148.
95. 73 DTC 5036.
96. 62 DTC 1390.
97. D.P. O'Connell, *International Law*, Second Edition (1970), page 253 as quoted in the *International Tax Treaties Service*, supra.
98. The problem is, of course, magnified when there is an apparent obscurity or conflict within the terms of the treaty. For example, it is understood that the Japanese are now considering the case of whether a German bank can charge a profit on financing its Japanese branch banking operation with the uncertainty stemming from the conflict between the applicable treaty provison based on Article 7, Paragraph 2, and Article 7, Paragraph 3, of the OECD Model. Paragraph 2 provides that the operations of a branch are to be accounted for on an arm's length basis, thereby imparting the notion of profit margins on intra-company transactions. On the other hand, Paragraph 3 suggests that deductions in computing the profit of a branch are restricted to an allocation of actual direct or indirect head office expenses. A similar type of dispute could arise under some of Canada's treaties aside from those under the OECD Model; consider for example, Article III of the Canada-U.S. Convention.
99. Supra note 55.
100. Supra note 46.

(a) What are industrial and commercial profits?

The question of industrial and commercial profits brings into operation the restrictions inherent in Article II, [101] giving rise to conceptionally difficult questions of reconciling the resulting strict limitations of Article I with the overall substance of certain situations.

(i) *Bank loan interest*

For example, bank loan interest income earned in the other country is strictly speaking ruled out by the exclusion of the Article II type. Although we have seen no jurisprudence, to my knowledge, under the Canada-U.S. Convention with respect to a bank interest situation, the similar issues in cases like *Western Electric* [102] and *Canadian Pacific* [103] and the restrictive interpretation in the Australian bank loan interest case of *E.J. and A. Bank Ltd.* [104] does not augur well for how Canadian Courts, at least, would view such an issue.

In *Western Electric* [105] the U.S. taxpayer supplied know-how to a Canadian manufacturer and was denied the protection of Article I because the arrangement was excluded by Article II and instead governed by the royalty provisions of the Convention. The issues in *Western Electric* were twofold:

— Were payments made by Northern Electric Company Ltd. of Canada to Western Electric Company Inc. of the U.S. as fees for technical information (with the fees computed as a percentage of sales of Northern) to be included as "royalties" within the meaning of paragraph 6(a) of the Protocol?
and
— If they were so included would the rule of Article II, that royalties are excluded from the exempt income contemplated by Article I (industrial and commercial profits), prevail so that withholding tax of 15 percent could arise under provisions of the treaty?

The findings with respect to the second issue are of particular interest for these purposes. It was held that since it could properly be said that the payments were "royalties", that the provisions of Article II were mandatory and, therefore, the payments could not qualify as industrial and commercial profits for the exemptive provisions of Article I. The question which arises is whether, in the context of the purposes and overall scheme of the treaty, Article I should in certain circumstances override the express provisions of Article II? Although the finding in relation to the facts in *Western Electric* [106] would appear to be within the spirit of the treaty (which was strictly applied), it is the absence of any examination of the interaction of Articles I and II which may be open to question.

The application of the decision in *Western Electric* [107] to the question of bank loan interest would, on the basis of the similar exclusion in Article II of "interest" as "industrial and commercial profits" (for the purpose of Article I), require a finding that a bank does not qualify for the exemption contemplated by Article I. Although, as noted, this issue has not come before either the U.S. or Canadian courts, it is the express position of the tax authorities in both countries.

However, where it was to the advantage of Revenue Canada, as in the case of *Canadian Pacific Ltd.*, [108] the converse was argued. That case involved a claim by Canadian Pacific for credit under section 126 of the Income Tax Act for taxes paid in the U.S. on rentals ("per diem") received on railway cars temporarily on U.S. rail tracks where the U.S. authorities had adopted the interpretation of Articles I and II in *Western Electric* [109] and had claimed and exacted a tax on that basis. The Canadian authorities sought to deny a credit on the basis that taxes should not have been paid in the U.S. because of Article I. The Federal Court found for Canadian Pacific (and this in accordance with the *Western Electric* interpretation) but primarily on the ground that, in the circumstances, consistency by the tax authorities on both sides would be more in keeping with the spirit of the treaty.[110]

The Court did in passing raise the possibility that a strict reading of Articles I and II could be derogated from if it could be shown that the activities of Canadian Pacific with respect to earning those rentals had been of an active nature; however, this point was not pursued by the Court but raised merely as a possibility. It would be interesting to see whether the comment by Walsh, J. at page 6135, that:

> *"While these receipts have certain aspects of both — industrial and commercial profits — as already stated, Canadian Pacific Ltd. did nothing to advance or promote this source of revenue which is the usual badge of a commercial or industrial enterprise"*

would serve as a basis for a claim by a bank, in the circumstances postulated for an Article I exemption.

It should be noted that in the Australian case of *E.S. and A. Bank Ltd.* [111] where there was a genuine ambiguity in that the expression "industrial and commercial profits" referred to activities of banking while the same term was defined not to include interest, the Australian Court held that the claimant bank did not qualify for exemption; if this approach were to be employed by the Canadian Court in respect to Articles I and II of the U.S.-Canada Treaty where the words are clear and, against the bank, strictly construed, then there would not be much hope for a departure from a literal construction. It is to be hoped that the courts would be more inclined to follow the opening provided

101. "(Rentals, royalties, interest, dividends, management charges and capital gains.) For the purpose of this Convention, the term 'industrial and commercial profits' shall not include income in the form of rentals and royalties, interest, dividends, management charges, or gains derived from the sale or exchange of capital assets.
Subject to the provisions of this Convention such items of income shall be taxed separately or together with industrial and commercial profits in accordance with the laws of the Contracting States."
102. Supra note 71.
103. Supra note 3.
104. 69 A.T.C. 4069.
105. Supra note 71.
106. Supra note 71.
107. Supra note 71.
108. Supra note 3.
109. Supra note 71.
110. Supra note 65.
111. Supra note 104.

by Walsh, J. in *Canadian Pacific* [112] in resolving the issues. It should be noted that a viable solution to the problem arises under the provisions of the Model OECD treaty, which by virtue of the inter-connected wordings of Articles 7 and 11 should serve to eliminate the type of problem that now exists under treaties featuring the type of wording in Articles I and II of the Canada-U.S. Convention.

The somewhat arbitrary results which arise in these types of international transactions, turning on particular and perhaps unintended differences in wording in treaties, can be seen by comparing the decision in *E.S. and A. Bank* [113] to that of *Twentieth Century Banking Ltd.* [114] involving the same issue under the U.K.-Jersey tax treaty. Because in that treaty the term "industrial and commercial profits" was not restricted by the type of definition in Article II of the U.S.-Canada Treaty, the Court had little difficulty in concluding that interest earned in the context of an ongoing banking operation was clearly industrial and commercial profit and thereby eligible for the usual permanent establishment — industrial and commercial profit exemption.

The *Rhodesian case* [115] held similarly with respect to rentals received on moveable property being leased in the ordinary course of a leading business. There seems to be little conceptual difference between these conflicting cases, challenging the Courts to seek common determinations regardless of the differences in which similar treaty provisions are worded.

(ii) *Recent developments respecting loan guarantee fees*

In *Associates Corporation of North American* v. *Her Majesty The Queen*, [116] a case heard before the Federal Court, Trial Division in early 1980, Revenue Canada went so far as to contend that loan guarantee fees are not eligible for Article I on the basis that they are really part of interest for the purposes of Article II, notwithstanding:

(1) that only specific deeming provisions in the Canadian Income Tax Act (section 214(15)) provide for such an assimilation;
(2) that the terms of the U.S.-Canada Convention are not required to be interpreted by reference to the law of the country claiming tax; and
(3) the very real difference between the earning of interest and the nature of a guarantee fee.

The Federal Court decided for the taxpayer.

(b) Enterprise for the purpose of Article I

Article I can have other surprises for the unwary, as straightforward as it may seem on a quick reading. Last November the Federal Court of Canada upheld a decision of the Trial Division in the case of *Rutenberg* [117] where a U.S. individual was denied the protection of Article I in respect of certain land trading activities in Canada although not necessarily carried out through a permanent establishment. The grounds for disqualification were that Rutenberg's activities did not comprise an "enterprise of one of the contracting States" within the meaning thereof in the protocol. The protocol definitions were construed to require that not only must the business be carried on by a person resident of the United States but, in addition, the activities in some substantial part must be carried on in the United States (see the requirement of "American enterprise" within paragraph 3(d) for the purposes of being considered "an enterprise of one of the Contracting States" within the meaning of paragraph 3(c) of the Protocol).

I take no issue at all with the decision in *Rutenberg* [118] but, having regard to a contrary finding by the Federal Court, Trial Division in *Masri* [119] in similar circumstances, I merely wish to make the point that it is difficult to disagree with D.P. O'Connell that there are very few treaty provisions which can be applied without the possibility of interpretative controversy. [120]

112. Supra note 3.
113. Supra note 104.
114. *International Tax Treaties Service*, p. 15 under the section on Article VII.
115. Supra note 64.
116. 80 DTC 6049.
117. Supra note 53.
118. Supra note 53.
119. 73 DTC 5367; see also *Abed* v. *M.N.R.* 78 DTC 6007. For a full discussion of these cases see Nathan Boidman, *The Concept of Real Estate Enterprise Under the U.S.-Canada Treaty: A Case Study*, Tax Management International, May 1978, 22.
120. The Canadian decision of *Number 473*, supra note 56, *Number 630*, supra note 58 and the U.S. decisions in *Johnston*, supra note 60, and *Donroy Ltd.*, supra note 59, are excellent examples of the uncertainties which can arise where a provision like Article I and related definitions suggest results on its plain words which are out of context with the domestic tax law which the treaty has been negotiated to modify. In each of these cases the taxpayer was a member of a partnership carrying on business in the other country and sought exemption from tax either in his own country or the country where the activities took place on the theory that the U.S.-Canada Convention establishes separate status for partnerships, thereby providing a shield for the partners against the domestic tax law otherwise applicable. In both the U.S. and Canada the tax treatment of partnerships is the same, with the activities and income of the partnership being effectively attributed to the partners who are then liable for tax on their distributive or proportionate share. The U.S. and Canadian courts in these cases had little difficulty in piercing the partnership veil sought to be created, rejecting the claim for Article I exemption which would have been clearly unwarranted in the circumstances — definitely good examples of contextual interpretations of treaty provisions, unfettered by the precise language employed in the treaty. For example, in *Number 630* a resident of the U.S., a partner in a Canadian partnership, had sought exemption from Canadian tax on the basis of Article I. The Tax Review Board stated:
*"What he (the taxpayer) did submit, however, was that under the Convention, already referred to, a partnership was an 'enterprise', therefore, by virtue of the Convention alone, could be regarded as an entity separate and distinct from the various partners. This argument is interesting and ingenious, but I do not think it can prevail. . . . in my comprehension and the meaning of this paragraph, 'enterprise' refers primarily to the work, endeavour, contract and task undertaken by some entity rather than to the entity itself. True, the word 'enterprise' is used rather loosely, perhaps not always consistently in paragraph 3(f) for instance, but all in all I think it was intended to have the meaning I have indicated. Furthermore, I do not think that the Convention nor Protocol is to be interpreted as though in conflict with the basic law of either of the contracting States by which the Convention was ratified."*
The case of *Number 630* (as well as that of *W.C. Johnston*

## E. THE INTERPRETATION OF A TREATY AS A CONTRACT; COMMENT RESPECTING UNILATERAL INTERPRETATION

I wish to conclude my remarks by dealing briefly with the question of interpreting a treaty as a statute as opposed to a contract or vice versa and I would like to look in particular at the very real difference between the Canadian and U.S. judicial approaches in respect of the effectiveness and relevancy of unilateral acts of interpretation or administration by the competent authorities of each country.

In Canada the judiciary jealously guards its right to interpret law and certainly in that context a tax treaty agreement is considered as much law as any other domestic tax statute. [121] For example, the Courts regularly dismiss out of hand any reference by a tax collector or taxpayer to Governmental interpretation of tax law in Interpretation Bulletins, Information Circulars or published tax rulings.[122]

Secondly, Canada, unlike the U.S., has only one type of regulation; in U.S. terms these would be called "legislative regulations". That is, the Government may make regulations where specifically authorized by statute and then within constraints of the principle that the regulation may not exceed the scope of the authority granted. The result of these particular features of our judicial and legislative system is that it is quite difficult for Revenue Canada or any administrative body to effectively change the provisions of Canada's tax treaties on a unilateral basis — which could be considered consonant with the requisites or principles of a contract.

On the other hand, it appears that the Treasury or the I.R.S. finds more sympathetic reception in the U.S. Courts for its interpretations of tax law generally including double tax agreements. For example, interpretative regulations (resting on the general authority granted by the Internal Revenue Code) are usually upheld on the grounds of presumptive validity unless the particular Court has sympathies to the contrary, in which case it might suddenly lose its presumptive validity. At one time there was a series of Treasury regulations made to assist in the interpretation or application of U.S. double tax treaties; such regulations are no longer issued. These regulations, even if outside the specific authority granted by the treaty, have frequently been accepted by U.S. Courts. For example, in *Jules Samann* v. *The Commisioner*, [123] a case involving the authority to be given a U.S. Treasury regulation respecting the Swiss-U.S. Treaty under the authority of Article 19 of the Treaty (whereby, "The two contracting States may prescribe regulations necessary to carry into effect the present Convention within the respective States"), the United States had made an interpretation of Article 8 which at the request of the Swiss Government had been submitted to Switzerland before being proclaimed in the U.S. As no objection was raised, it was thus considered by the Court that the Swiss Confederation had, at least tacitly, approved the regulation and acquiesced in it. The Court stated:

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and *Donroy)* confirm the rule that a permanent establishment of a partnership is attributed to a partner for the purposes of Article I:

*"It appears to me that the four partners of which the appellant was one, had set up a head quarter, or whatever one may wish to term it, in Ontario, where the office premiums used by the partnership were to be found. I have the greatest difficulty in considering that office not to be the office of the appellant also and, in fact, cannot do so. It appears to me that the office premises of the partners collectively, were also the office premises of any one partner."*

121. A tax treaty has no effect in Canada until it has been enacted by Parliament, in the same fashion as any other statute.
In both Canada and the U.K. there is strong jurisprudence tending to view a treaty as a statute at least in respect of the right of the Sovereign Parliament of a Contracting State to unilaterally change its terms. See, for example, The House of Lords decision in *I.R.C.* v. *Colloco* 39 TC 509 (HL) where Viscount Simonds stated at page 548:
*"... neither comity nor rule of international law can be invoked to prevent the Sovereign State from taking what steps it thinks fit to protect its own revenue laws ...."*
Section 34(1) in the Interpretation Act RSC 1970, C.I-23, of Canada, provides that:
*"Every Act shall be so construed so as to reserve to Parliament the power of repealing or amending it and of evoking, restricting or modifying any power, privilege or advantage thereby vested in or granted to any person."*
Section 34(1) must be read having regard to the fundamental rule that a tax treaty in Canada does not have force of law unless enacted by statute: See *Attorney General for Canada* v. *Attorney General for Ontario* (1937) AC326, at page 346:
*"Within the British Empire there is a well established rule that the making of a treaty is an executive act, while the performance of its obligations, if they entail alteration of the existing domestic law, requires legislative action. Unlike some other countries, the stipulations of a treaty duly ratified do not within the Empire, by virtue of the treaty alone, have the force of law. If the national executive, the Government of the day, decides to incur the obligations of a treaty which involves alteration of law they have to run the risk of obtaining the assent of Parliament to the necessary statute or statutes."*
See also J.G. Castel, *International Law Chiefly As Interpreted And Applied In Canada, Toronto, Butterworths,* 1976, at page 938:
*"There are two situations which require Parliament's intervention before an agreement can be ratified. First, when the agreement itself provides that it must be submitted to the legislative authority of each of the contracting powers. Secondly, when the provisions of the agreement run counter to the statutes of Canada and when its implementation within the country necessitates an amendment to our statutory laws. Only the Parliament of Canada can amend any statutes and bring them into harmony with provisions of the agreement involved."*
Finally, in this respect it should be noted that a statute enacting a tax treaty generally has a conflict rule which provides that the provisions of the tax treaty will render inoperative any competing or conflicting domestic tax rule. However, such a constraint is itself the creature of Parliament and can be amended.
The U.S. situation is presumable the same. See, for example, the pending legislation respecting foreign investment in U.S. real estate which would nullify conflicting treaty provisions after a five-year renegotiation delay.
122. Such interpretation will be given no greater weight than other knowledgeable (but non-binding) commentary on the law; see *Harmon*, supra note 81, *B.C. Railway*, supra note 80, *Bruster* v. *The Queen*, 76 DTC 6046, *Stickel*, supra note 4 and *Canadian Pacific*, supra note 3. However, see the Supreme Court decision in *Harel* v. *Deputy Minister of Revenue of Quebec* 77 DTC 5438 where federal tax administrative practice was held to be persuasive in interpreting a provincial taxing statute.
123. 313 F. 2d 461; 36 T.C. 1011.

"*A regulation . . . is endowed with the presumption of validity . . . . No offense is done our understanding with the Swiss when, with their consent, we imbue the terms of the exemption with the meaning they import in the tax language of the U.S. . . . .*"

See also *Maximov*, [124] *Lewenhaupt* v. *Commissioner* [125] and *Simenon* v. *Commissioner* [126] where the U.S. Court said:

"*It is well settled that a regulation of long standing . . . promulgated by the Department charged with the enforcement of a statute, is entitled to great weight and will be followed unless unreasonable or inconsistent with the statute involved.*"

## F. CONCLUDING COMMENT

If there is a message to be extracted from the foregoing and the other papers presented at this meeting, it is that there are sufficient problems in the tax treaty area to keep us coming to I.F.A. meetings for the foreseeable future.

124. Supra note 46.
125. 20 T.C. 151.
126. 44 T.C. 820.

# Conference Diary

### SEPTEMBER 1980

*Business International Institute/Asia:* Doing business in and with Thailand (Seminar) (including taxation), Bangkok (Thailand), September 1-2 (English).

*International Tax Institute, Inc.:* ITI Tax Seminar (including: How to maximize the foreign tax credit; intercompany pricing of sales to foreign subsidiaries; U.S. taxation of foreign nationals employed in the U.S.), Stamford (U.S.A.), September 9-10 (English).

*Business International Institute/Asia:* Doing business in and with Korea (Seminar) (including taxation), Seoul (Republic of Korea), September 15-16 (English).

*IXth Luso-Hispano-Americanas Meeting of Tax Studies:* Influence of taxation on the financing of enterprises; the family unit as taxable subject, Porto (Portugal), September 28-October 3 (Portuguese, Spanish).

*34th Annual Congress of I.F.A.:* I. The dialogue between the tax administration and taxpayer up to the filing of the tax return: II. The determination of the source of income. For the seminar the subject is the flight to tax havens, their use and abuse, Paris (France), September 14-19 (English, French German, Spanish).

### OCTOBER 1980

*Seminar Services International:* The 4th Multi-Choice International Corporate Finance Conference (including: Tax aspects of international financing operations), London (United Kingdom), October 29-30 (English).

### NOVEMBER 1980

*Confédération Fiscale Européenne (C.F.E.):* Second Congress of European Tax Consultants (subject: "La pratique de la Fiscalité en Europe"), Rome (Italy), November 6 and 7 (English, French, German).

*Management Centre Europe:* International Tax Management Seminar (Discussion of tax problems in today's multinational environment), Munich (German Federal Republic), November 10-11 (English).

*Management Centre Europe:* Managing and developing foreign subsidiaries (including: Tax in international operations), Munich (German Federal Republic), November 12-14 (English).

*Management Centre Europe:* Leasing Seminar (including: Tax aspects of leasing), Brussels (Belgium), November 26-28 (English).

### DECEMBER 1980

*Management Centre Europe:* International cash management (including: International tax aspects in cash management), London (United Kingdom), December 8-10 (English).

### APRIL 1981

*Management Centre Europe:* Fourth MCE International Tax Conference. Chairman: Prof. J. van Hoorn Jr., Co-Chairman: A.G. Davies C.B.E. Main subjects: Transfer pricing; Government and business views on tax avoidance; Taxation of international leasing; small meeting groups directed by members of the faculty, Munich (German Federal Republic), April 8-10 (English).

### SEPTEMBER 1981

*35th Annual Congress of I.F.A.:* I. Mutual agreement procedure and practice; II. Unilateral measures to prevent double taxation, Berlin (German Federal Republic), September 21-25 (English, French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

Associação Fiscal Portuguesa, Rua das Portas de Santo Antão 90, 1100 Lisbon, Portugal.

Business International Institute/Asia, 301-305 Asian House, One Hennessy Road, Hong Kong.

Confédération Fiscal Européenne, Secrétariat Général (C.F.E.), D-5300 Bonn 1, Dechenstrasse 14, German Federal Republic or Siège Social F-75009 Paris, 9 rue Richepanse (France).

International Fiscal Association (I.F.A.): General Secretariat, Woudenstein, Burgemeester Oudlaan 50, P.O. Box 1738, 3000 DR Rotterdam (the Netherlands).

International Tax Institute, Inc., 17 Danbury Road, Ridgefield, Connecticut 06877, U.S.A.

Management Centre Europe, Avenue des Arts 4, B-1040 Brussels (Belgium).

Seminar Services International, 54 rue du Faubourg Saint-Honoré, F-75008 Paris (France).

# TAX GLOSSARY

by H.W.T. PEPPER *

**TAX BURDEN** — The tax burden, or tax ratio, in a country is computed by taking the total tax payments for a particular fiscal year as a fraction or percentage of the G.N.P. or national income for that year.

**TAX CLEARANCE CERTIFICATES** — In some countries "tax clearance" certificates have to be obtained from the income tax department to indicate that the individual has no income tax arrears. The certificate must be shown to the Emigration or Customs authorities on leaving a country. Without it the individual may be prevented from leaving. In a few countries such a certificate has to be obtained for other purposes, e.g., as pre-requisite to tendering for a government contract, or obtaining a driving licence.

**TAX COMPLIANCE** — The term refers to the degree to which taxpayers respond to their statutory duty to declare their incomes and provide the information required for the calculation of their income tax, sales tax, etc., and pay on time the tax due from them.

**TAX-COMPOUNDED** — A system whereby Building Societies in Britain pay interest to their depositors in "tax-compounded" from is described under BUILDING SOCIETY ARRANGEMENT (q.v.). Interest and other income paid in this form do not normally involve the recipient in further tax liability (although in Britain the compounding relates only to the standard rate of income tax and the recipient incurs a liability to higher tax rates if his total income is above certain limits). The tax payable by the recipients as a body is accounted for by the body or organisation which pays out the income in tax-compounded form.

**TAX CONSCIOUSNESS** — The degree to which an individual is aware of his duties under taxing laws and/or of the amount of tax he eventually bears in one form or another. (See, by contrast, UNMERKLICHKEIT.)

**TAX CREDITS** — Where, under an income tax system, a taxpayer has borne tax by deduction or withholding on certain items of income which are included in his aggregate assessment, a credit may be due on such tax against the tax computed on the aggregated income. In the case of value added taxation, a credit may be due for tax charged to a trader by other traders from whom he has obtained his supplies. In a transition from one type of sales tax to another where old tax has been borne by goods in hand at the commencement of the new tax, a credit may be due, when computing the new tax on disposal of the stock in hand at its commencement. (See, however, BUFFER RULE.)

**TAX DECLARATION** — See DECLARATION, TAX.

**TAX DEPOSIT ACCOUNT** — An account held by a U.K. company to accumulate cash with which to pay MAINSTREAM CORPORATION TAX (q.v.). Interest is credited by the Inland Revenue Department, but where cash is withdrawn from the account for a purpose other than tax payment the rate of interest allowable is reduced.

**TAX EFFICIENCY** — There are often various different ways of undertaking commercial transactions and the tax treatment may vary according to the manner in which things are done.
For example, it may be a marginal decision whether or not to incorporate a small business, whether to rent premises and equipment or purchase them. A company has to decide what proportions of its working capital requirements should be in equity, fixed interest debentures, bank overdraft; etc.
Other factors are, of course, involved in making the decision but if other things are equal, the decision producing the most favourable tax position will be the most "tax-efficient" one.

**TAX EQUALITY** — See EQUITY, DOMESTIC TAX EQUALITY, and GRADUATION.

**TAX EVASION** — See EVASION.

**TAX-EXCLUSIVE BASE** — See TAX-INCLUSIVE BASE.

**TAX-EXCLUSIVE PRICE** — See TAX-INCLUSIVE PRICE.

**TAX EXIT CERTIFICATE** — See TAX CLEARANCE CERTIFICATE.

**TAX "FARMING"** — The system of appointing persons to collect a tax imposed by the monarch or the central government, often by the establishing of a series of quotas or sums required in total yield from different regions, the tax farmers being given discretion as to how they achieve the quota or target set. The system has many drawbacks, the chief among which is that tax farmers normally collect excessive amounts from those that they are able successfully to dun and retain an undue proportion of the gross yield. The system was used in Roman times, to some extent in medieval Britain, and in many other countries in other epochs, but is not nowadays regarded as an equitable method of tax administration.

**TAX FINANCE** — A term sometimes used to refer to the process by which provision is made by a business for payment of tax liabilities of which it must take account, e.g., in its balance sheet and in cash flow computations.

**TAX FORMS** — See FORMS, TAX.

**TAX-FREE** — The term "tax-free" is sometimes used, when strictly, the term "tax-exempt" should be applied, to mean that an item of income or a transaction is *exempt* from tax. The term is also used to mean that someone else is paying the tax and the recipient is thus "free" of any liability to *pay tax* although the tax is borne by him. See also TAX-FREE PAY.

**TAX-FREE PAY** — In the calculation of the amounts to be deducted or withheld by way of income tax on employees' remuneration under P.A.Y.E. schemes, it is usual to supply official tables which, under some systems, enable the tax to be ascertained at a glance after deducting from total pay the "tax-free" pay, i.e., the various deductions and personal reliefs to which the tax-payer is entitled for the

* With the assistance of the staff of the International Bureau of Fiscal Documentation.

period of the deduction. The tables apply the operative graduated rates to the (taxable) balance of the income.

**TAX-FREE SHOPS** — Shops which are usually situated within the boundaries of an airport or sea-port from which outgoing passengers may purchase goods which are free of sales taxes and other indirect taxation, since the purchases are clearly destined for export. In some countries *incoming* tourists may acquire a personal allocation of liquor or tobacco from duty-free shops before entering the Customs area of the country in which the airport is situated.

**TAX-FREE ZONE** — An area within the territory of a country may be designated a "tax-free zone" in which customs duties and other indirect taxation are not applied, partly because the area may be used in connection with entrepot trade or export industries based on imported raw materials where, if indirect taxation were applied, it would mostly have to be refunded. Sometimes income tax exemptions or abatements are also allowed in respect of profits from activities within the zones. Where goods pass from the zone into the remainder of the country the normal duties and taxes are usually applied. Examples of tax-or-duty-free zones include the Kaohsiung "export processing zone" in Taiwan, the Shannon airport zone in Eire, and designated areas in many of the world's large ports within which goods may be imported and re-exported without entering the general customs area of the country as a whole.

**TAX FROM TAX** — This term is sometimes applied to the "invoice system" of V.A.T., under which the trader who is liable to pay value added tax on his sales may deduct therefrom the tax charged to him by his suppliers. The term also applies in income tax systems where double tax relief in respect of tax paid in other countries on the income assessed in the taxing country takes the form of a deduction for the foreign tax against the local tax.

**TAX HAVEN** — A country with low tax rates on income (or no direct taxes at all). The term also includes countries with normal tax systems but whose income tax codes provide some "shelter" (see TAX SHELTER) or exemption for particular types of income which makes them attractive to non-residents. The relief from income tax is normally partly offset by sundry initial and annual registration fees which form an important source of revenue for the tax haven country.
Because of ever more tortuous and artificial devices being contrived by tax advisers to avoid taxation in countries with high tax levels, tax havens have tended to fall into disrepute. They are tending to seek respectability by exercising a little more control over the type of person operating therein and the nature of the business (including offshore banking) conducted. See also FINANCIAL CENTRE, OFFSHORE BANKS, COMPANIES, TRUSTS, SHIPPING CENTRE.

**TAX HAVEN, ART** — A tax measure, unique to the Republic of Ireland, exempts from income tax earnings from original and creative work, having cultural or artistic merit, by established writers, artists, etc. Introduced in 1969 to halt the "intellectual drain", or "brain drain" from Ireland, the exemption has attracted foreign writers, artists and others to set up residence in the country, which for other taxpayers has an orthodox fiscal system.

**TAX HOLIDAY** — A tax holiday is generally understood as the period of exemption from income tax for new industries, granted by certain countries, as a method of trying to develop or diversify their industries. The exemption is usually given for a term of years to "pioneer" or "infant" industries (see also PIONEER INDUSTRY). Countries which tax all income for income tax purposes in the year after it accrues, or is received, are sometimes said to operate a "one year tax holiday" system although, of course, the "holiday" merely defers the tax liability which deferral nevertheless provides a welcome benefit in cash flow terms.

**TAX-INCLUSIVE BASE** — Under a sales tax regime the tax may be calculated on the actual sale prices of goods and services. Since the entrepreneur has to charge prices to consumers which include the sales tax element, to charge tax on the total sales proceeds not only involves taxing the tax-exclusive prices of the goods but also the tax element in their prices, so that there is a levy of "tax on tax". The levy of sales tax on the tax-inclusive price is fairly normal for a retail tax (the State retail taxes in the U.S. are an exception, being charged on tax-exclusive prices), but with manufacturers' and wholesalers' taxes it is more usual to levy the tax on a price or value which excludes tax — this is the position, for example, with regard to the Canadian manufacturers' tax. As regards V.A.T., some systems tax the tax-inclusive price but the current trend is to charge the tax on the tax-exclusive price. At least in theory, application of sales taxes to the tax-exclusive price should be less likely to involve price ESCALATION (q.v.) or pyramiding since the price of the goods and the tax element are separately indentifiable. See also TAXABLE BASE.

**TAX-INCLUSIVE PRICE** — The price of goods or services which includes indirect taxation thereon. Where such tax is excluded from the price quoted, that price is said to be the tax-exclusive price (see also TAX-INCLUSIVE BASE).

**TAX INVOICE** — See INVOICE, STATUTORY.

**TAX LAW** — Apart from the statute by which a tax or duty is imposed, the law which is relevant to the incidence and computation of tax includes decisions of tax tribunals set up under the tax legislation, and also the decisions of the Courts where matters of interpretation, etc., have been taken for rulings. In addition, there may be statutory rules and orders made by the legislature in a manner less formal than the amendment or extension of the basic statute law. The incidence of the tax may be partly regulated also by double tax treaties with other countries. In addition, agreements, particularly between governments and concerns exploiting mineral or forests, or providing public utilities, such as cable, wireless and telephone services, the production of electricity, etc., are sometimes made which contain clauses governing the application of taxation to the entrepreneur, which may wholly or partially supersede some of the tax laws.

**TAX-LOSS COMPANY** — Where a company has been making losses in its trade which have not been allowed for income tax purposes, the losses may have attractions for another company which is in a position to take over the unsuccessful company because the former may be able to put the losing company on a profitable basis and thus obtain the benefit of the losses, which will reduce or eliminate the tax liability in the early years of profitability. Accordingly, a tax-loss company may have a value in respect of its accumulated losses which may even exceed the value of its more tangible assets. To prevent tax avoidance through "trafficking" in tax losses, the tax law will commonly have some provision that the losses cannot be allowed on a change of ownership unless the original business is continued in identifiable form.

**TAX LOTTERY** — See LOTTERIES for CONSUMERS.

**TAX, MAXIMUM** — See MAXIMUM TAX.

**TAX, MINIMUM** — See MINIMUM TAX, TAX PREFERENCES.

**TAX NEUTRALITY** — See NEUTRALITY.

**TAX ON TAX** — Tax may be levied on tax in an income tax context where an employer undertakes to pay an employee's remuneration "tax-free". The term usually means that the employer will be responsible for the tax in this instance and that the remuneration which the employee receives will represent his "take-home pay" as far as income tax is concerned. The employer then has to account for tax on a figure for gross remuneration which, after being subjected to income tax, would leave a net payment equal to the tax-free remuneration. To compute this gross figure, however, it is clearly not sufficient to calculate tax on the net remuneration and then add these two figures together, because the tax on a gross figure thus obtained would clearly be greater than the tax on the net remuneration. Accordingly, a GROSSING-UP (q.v.) operation is required in order to determine tax not only on the net remuneration but on the tax which the employer is to pay. As regards sales tax, "tax on tax" relates to the charging of tax on TAX-INCLUSIVE PRICES (q.v.).

**TAX-OPTION CORPORATION** — Under U.S. Internal Revenue legislation, a tax-option corporation is a corporation (company) which is entitled to opt for various forms of special tax treatment under Sub. Chapter 5 (Sections 1371-1377) of the Code. (See also SMALL BUSINESS CORPORATION.)

**TAX PERFORMANCE** — This term, which is equivalent to "tax burden" and "tax ratio", refers to the "performance" of the Government in mobilising a country's resources for defraying government expenditure by taxation and is usually expressed as a percentage which total tax receipts bear to G.N.P. or national income.

**TAX PERIOD, STAGGERING OF** — See PAYMENTS, SPREADING OF.

**TAX PLANNING** — The term may in some cases be merely a euphemism for tax avoidance, but may also be more than that. It is important for a business to take tax into account when making decisions on how it shall conduct its affairs, and hence that it should try to find the most tax-efficient way of doing things. See TAX EFFICIENCY.

**TAX POINT** — This term refers to the point or stage at which indirect taxes are levied; for example, in V.A.T. schemes the tax usually arises upon delivery of the goods or the issue of the invoice, whichever event is earlier. In the Brazilian V.A.T. scheme (I.C.M.), the tax is payable when goods are moved from the premises of the seller (see also TAXABLE EVENT).

**TAX PREFERENCES** — A term used in the U.S.A. in connection with MINIMUM TAX (q.v.) which is levied at the rate of 10 percent (previously 15 percent) on the amount by which the preferences exceed $30,000 plus the income tax for the year. "Preference" items in the case of a corporation include such things as:
(a) excess of accelerated depreciation over straight-line depreciation;
(b) excess of percentage depletion over adjusted cost basis depreciation.

There are broadly similar provisions in respect of tax preferences granted to individuals.

**TAX, PREFERENTIAL STATUS OF DEBTS FOR** — Because taxes are a debt to the State and thus, in a sense, to the general public, it is usual to provide in tax laws or commercial codes that debts for tax should take preference over other debts, for example, in a bankruptcy of an individual, or the winding up of a company, as well as in the administration of the estate of a deceased person.

**TAX PUSH** — One of the causes of monetary inflation is the increase of prices occasioned by an increase in the cost of factors of production, e.g., labour. Inflation cuased by increased wages and salaries is sometimes known as "Wage-push" inflation. Where the cause is increased taxation (especially indirect taxation on commodities and services) the term "tax push" inflation is used.

**TAX RATES** — The rate of tax is usually expressed either as a percentage, or in terms of currency, e.g., as so many pence in the pound, cents in the dollar, as far as taxes on capital and income are concerned. As regards indirect taxation, ad valorem duties and taxes are also usually charged at a percentage rate on the sale of goods and services. Graduated rates are commonly applied where the capital or income of individuals in being taxed, and flat rates are used in applying indirect taxes. (See also CORPORATION TAX, GRADUATION, SCHEDULAR TAXES, and, by contrast, SPECIFIC DUTIES.)

**TAX RATIO** — The ratio which the total tax yield of a country bears to G.N.P. or national income. (See also TAX BURDEN.)

**TAX, REGULATOR** — See REGULATOR, TAX.

**TAX RESERVE CERTIFICATES** — Certificates which were formerly on sale in the U.K. as a means of prepaying income tax, etc. The certificates bore tax-free interest and could be bought in advance of the due date of taxes and then presented in payment therefor. See, also, TAX DEPOSIT ACCOUNTS.

**TAX, RESOURCE** — See RESOURCE TAX.

**TAX SECURITY** — See SECURITY FOR TAX.

**TAX SHADOWING** — The term applied to the process of the "matching", by one country the tax imposed in another country, on income which is taxable in both, so as to avoid the frustration of double taxation relief which could arise where income is computed on different bases by the two countries concerned. The term also covers the TAX-SPARING PRINCIPLE (q.v.) whereby one country gives relief for PHANTOM TAX (q.v.) resulting from tax holiday legislation in the other.

**TAX SHELTER** — The term is used in the U.S.A. to mean tax relief or exemptions generally, and includes items such as oil depletion allowances, the exemption from tax of the interest on certain municipal bonds, relief for large charitable donations.

**TAX SHIFTING** — See SHIFTING OF TAXES.

[to be continued]

# Zambia: Tax Changes in the Budget for 1980

by A.B.C. Emmanuel

As far as Income Tax is concerned the 1980 Budget brought no significant changes except for two concessions in regard to capital allowances. The Minister of Finance had promised to make some changes to some of the taxes imposed in the 1979 Budget and these have now been implemented by the Income Tax Admendment Act, No. 6 of 1980.

## Rates of tax

(a) The rates of tax on individuals and companies remain the same.
(b) The rates of tax for withholding taxes also remain the same.

## The changes

*1. Capital allowances*

(a) The limitation of the allowable cost of vehicles for capital allowances purposes to K 4,000 has now been increased to K 6,000.
(b) The ceiling allowed for the purpose of capital allowance on low cost housing has been raised from K 4,000 to K 8,000.

*2. Donations*

Section 41 of the Income Tax Act has been amended to include donations to "funds of a public character wholly and inclusively established for the use of the Republic".

Donations to the Bridges Reconstruction Fund would come into this category.

*3. Undistributed profits tax*

Under the provisions of Section 95(1) of the Income Tax Act 1966 (as amended) the Commissioner of Taxes had the power to treat a company's profits or a proportion thereof as distributed to its shareholders. This deeming was applicable to certain classes of companies and it was left to the discretion of the Commissioner to deem the amount of the distribution without causing detriment to the company's business.

In the 1979 Budget this section was repealed and replaced by a new Section 95. Under this regulation the Commissioner would not deem a distribution but would charge a tax of 35 percent on the undistributed profits of a company in addition to the corporate tax of 48 percent.

This tax would be charged on all companies except those which are controlled directly or indirectly by:

(a) the Government, i.e. mostly companies controlled by ZIMCO Ltd.;
(b) quoted companies, i.e. companies whose ordinary share capital may be bought or sold on a stock exchange market.

The Commissioner then imposes the tax using a formula to decide the quantum of the undistributed profits. The formula is $A - (B + C + D)$ in which:

A = the amount of the profits
B = (i) 30% of the *industrial profits*
(ii) 20% of the *trading profits*
(iii) 10% of *rent* or *income in respect of professional services*
C = the amount of tax charged for the year
D = the amount distributed as dividends within the "specified period"

"Industrial profits", "trading profits", "specified period", "profits" have all been defined for the purposes of this section.

This regulation did not come into force due to criticisms made by various bodies on the grounds chiefly that:

(a) the section has been badly drafted; some of the definitions were very vague and left the taxpayer in a state of uncertainty as to what was to be included or excluded in the calculation of the undistributed profits;
(b) the formula was too rigid and left no room for expansion and reinvestment, and did not consider the liquidity position of the companies;
(c) the Commissioner has been given too much discretion and wide powers and the concept of detriment was no longer applicable now, unlike in the previous section.

*The International Bureau of Fiscal Documentation is pleased to publish an article on the Zambian Budget for 1980 by its correspondent for Zambia, Mr. A.B.C. Emmanuel.*

*Mr. Emmanuel, who is currently Tax Manager of Price Waterhouse & Co. in Lusaka (Zambia), graduated in 1945 from the University of Ceylon where he received his B.A. (Hons) Econ. In 1946 he joined the Income Tax Department (now Inland Revenue Department) of Sri Lanka where, after a scholarship in 1961 to the United Kingdom to study taxation at Somerset House, he was in 1963 promoted to Assistant Commissioner. In 1973 he joined the Department of Taxes of Zambia where he was in charge of the Withholding Tax District through 1978. In 1979 he joined Price Waterhouse & Co.*

The Minister did not do away with this regulation but in his 1980 budget speech promised to bring about changes that would make it more flexible and allow for more expansion in business, keeping in mind reinvestments, reasonable reserve levels and other safeguards for the business.

The Minister's proposals have now been put into effect by the Income Tax Amendment Act No. 6 of 1980. Sec. 95 states "Sec. 95 of the Principal Act is amended by the deletion of subsections (1), (2) and (3) and the substitute thereof of the following subsections:

"(1) For the purposes of this section:
'taxed profits' means the balance of a company's trading and profit and loss accounts after any adjustments thereto as determined by the Commissioner and after subtraction therefrom of the tax charged under the other provisions of this Act;
'Undistributed profits' means such part of the taxed profits of a company as remains undistributed as dividends after nine months starting from the end of the charge year or, as the case may be, from the end of the period for which the accounts prepared by such company are accepted by the Commissioner in accordance with the provisions of Section 62.

(2) Subject to the provisions of subsection (3) a company shall be charged additional tax at the rate of 35 percent of the amount of its undistributed profits.

(3) In determining the amount of undistributed profits of a company for the purposes of this section, the Commissioner may take into account such of the company's expansion or other needs as, to his satisfaction, are normal business practice and reasonable in the particular circumstances."

This new amendment does not clear the debts and uncertainties that arose in the 1979 amendment. The number of definitions has of course been reduced but the two new ones still leave the taxpayer in a state of uncertainty. Besides, there is now no formula for the Commissioner to determine the quantum of the undistributed profits and it is left to the discretion of the Commissioner who is given wide powers. The successful implementation of this new regulation will depend on the good intentions of the officials of the Department of Taxes, because in trying to find out what are "taxed profits" one has to see what the "adjustments" are which the Commissioner would make and in quantifying the amount of "undistributed profits" one has to see that the Commissioner in his *discretion* takes into account "such of the company's expansion or other needs as, to his satisfaction, are normal business practice and reasonable in the particular circumstances".

The Commissioner of Taxes has fortunately now issued a *Practice Note* laying down the Department's interpretation of this Section and also outlining the Department's practice in relation to this Section. The Department "recognises that the paramount considerations in determining distribution of profits as dividends, that might be made by companies, is the financial requirements of the business." But it is also aware that there are some companies which do not plough back some of their profits into the business for expansion purposes, nor distribute them adequately to their shareholders. This new regulation will therefore be used by the Commissioner, in his discretion, as a regulatory measure keeping in mind the welfare growth and expansion of the business.

In arriving at the "taxed profits" the Commissioner of Taxes would make the "adjustments" that are normally made for income tax purposes under the Income Tax Act 1966 (as amended). As a preliminary basis the Department will consider using the following formula to determine the amount of undistributed profits.

| | | |
|---|---|---|
| Profits as per accounts | | A |
| *Add* Disallowable items such as Depreciation of capital expenditure and expenditure specifically prohibited as deductions | | B |
| | | C |
| *Deduct* | | |
| Capital allowances and items specifically allowable | D | |
| Tax charged | E | |
| Dividend declared | F | G |
| Undistributed Profit | | H |

However the amount at H may be further reduced, completely or partially, provided the taxpayer can submit a detailed expansion or reinvestment plan supported by documentary evidence as acceptable to the Commissioner. To help the taxpayer who may be liable to this tax, the following "allowances" on their own *or in conjunction* with detailed expansion and reinvestment requirements, as mentioned above, may be used to reduce the amount arrived at as "H". These are:

(a) in the case of *industrial profits*, the maximum amount of the allowance may be equal to 30 percent of such net profits;
(b) in the case of *trading profits*, the maximum amount of the allowances may be equal to 20 percent of such profits;
(c) in the case of profits falling in neither of the abovementioned two categories, the maximum aount of the allowance may be equal to 10 percent of such net profits.

For the purposes of calculating these "allowances" the Department has decided that *industrial profits* "would include so much of the profits of a company adjusted for income tax purposes as is attributed to:

(i) the construction of buildings, plant and machinery, roads, bridges, water conservation or other operations deemed by the Commissioner to be of a like nature; or
(ii) farming; or
(iii) mining; or
(iv) manufacturing; or
(v) the carriage of passengers or goods; or
(vi) hotel keeping; and the

*Trading profits* would include so much of the profits of a company as adjusted for income tax purposes as are not attributed to:

(i) industrial profits; or

## SUMMARY OF SOME IMPORTANT TAX RATES

| | |
|---|---|
| Income tax on companies | 48 percent |
| Income tax on individuals: | |
| First K 1,000 | 5 percent |
| Next K 1,000 | 10 percent |
| Next K 2,000 | 20 percent |
| Next K 2,000 | 30 percent |
| Next K 2,000 | 45 percent |
| Next K 2,000 | 55 percent |
| Next K 2,000 | 65 percent |
| Balance | 70 percent |
| Withholding taxes on payments to non-residents: | |
| – dividends | 20 percent |
| – interest | 30 percent |
| – royalties | 30 percent |
| – public entertainment fees | 30 percent |
| – management and consultancy fees | 30 percent |
| – real property rentals | 30 percent |
| – payments to contractors for construction or haulage operations (transportation of persons or merchandise) | 25 percent |

See for a comprehensive description of the Zambian tax system our publication: *African Tax Systems/Systèmes fiscaux africains.*

(ii) rents; or
(iii) professional services.

Once the amount of undistributed profits has been determined by the Commissioner, he would then issue an assessment in the form of a directive stating the amount of the undistributed profits and the tax thereon. The provisions in Part viii and xi of the Income Tax Act 1966 (as amended) relating to collections, recovery of refunds, objections and appeals will apply to all such directions.

The Commissioner has also decided that where the *pre-tax* adjusted profits of a company are K 3,000 or less, an Undistributed Profits Tax assessment would not be made. This decision, purely for administrative reasons, is to relieve the department of spending time on small cases.

It should be noted that most of the concessions given in the Commissioner's Practice Note were in fact part of the law in the 1979 budget. These open the door for negotiations with the Commissioner since each company now has to put up its case for expansion and reinvestment in order to avoid the necessity of paying this tax. But before putting its case, in arriving at 'H' the Commissioner states that "expenditure" specifically prohibited will be added back and only items specifically allowable would be deducted. "Expenditure incurred in the production of income" is allowed for tax purposes under Sec. 29, but then what of losses which are dealt with in Section 30 of the Income Tax Act? It would appear unfair for a company which has large carry forward losses, but a profit in a particular year, to be liable to U.P.T. Many companies have repayments of outstanding loans which tend to eat into their liquidity position. Such repayments are not "allowable expenditure" in computing profits. It is hoped that the Commissioner of Taxes will consider these when looking into the detailed expansion and reinvestment plan and granting the "allowances" to each company.

Another fear is whether the Department is sufficiently equipped and geared to deal with each case without causing hardships and delay in determining each case. With so much "discretion" being given to the tax officials it is hoped that they will consider the welfare of the company and use this provision as a regulatory measure rather then a penal one.

### Job credits

This concession which was introduced but not put into effect in 1979 has now been changed by the Income Tax Amendment Act No. 6 of 1980. The former Sec. 90 A has been repealed and replaced by the new one which states that the Minister "may by a statutory order provide for the granting of job credits in such amounts, for such periods and for such employees of such business as may be prescribed therein."

We now await the publishing of the statutory order.

### Industrial Development Act

Frequent reference has been made in recent months by the Minister of Finance to the Industrial Development Act. This Act was passed in 1977 to supersede the Pioneer Industries (Relief from Income Tax) Act 1965. The purpose of the Pioneer Industries Act was to encourage the establishment of new industries, to strengthen and diversify the economy of the country, provide additional avenues of employment of labour and act as an incentive for the investment of capital.

The nature of the incentive was relief from income tax for a period of two to five years depending on the amount of capital put into the new project. It is important to note that the relief was limited to new industries or to those which are not being carried on at present on substantial commercial fashion.

The new Industrial Development Act was intended to go further than the Pioneer Act. The Act was to "provide for the licencing and control of manufacturing enterprises to provide incentives for investment, to regulate the making of contracts relating to the transfer of foreign technology and expertise to enterprises operating in Zambia and to provide for matters connected with or incidental to the foregoing".

Although it was passed in 1977 it has not proved helpful to industry and investment. The Minister has therefore agreed to pass regulations which will provide clear guidelines for investors and also provide fuller details of the incentives that are available to them.

The Industrial Development Act does not specify any period for or time limit to the reliefs but states that "relief from Income Tax, Sales Tax, S.E.T. for *such period, and in such manner* as the Minister responsible for the administrative thereof may prescribe". Similarly for customs duties, tariffs, import licences, rebates, etc., all such reliefs depend on the Minister responsible provided certain stipulated conditions are fulfilled.

It is now hoped that regulations will be passed specifying the actual working of the reliefs and the conditions to be fulfilled.

These regulations, it is hoped, will provide clear guidelines for investors and with the added incentives offered by the job credits facility, the Minister of Finance hopes that the business community would help in expanding the economy of the country.

## SERVE THE LORD AND SAVE TAXES -- THE ULTIMATE TAX H(E)AVEN

**(from our ecclesiastical correspondent)**

*A few months ago, the Financial Times reported that the export of Bibles from Britain had suffered a serious cut. U.K. publishers may well find an enlarged market in the United States if a new project develops well.*

*Religion has always been considered a serious matter in that country. As was, not so very long ago, taxation. It was, until recently, only the Bible where the relationship between religion and taxes was set out (e.g. "Render unto Caesar what is Caesar's etc."). This relationship has now received a new momentum as a result of the activities of a new profession: tax advising ministers. The following is an extract from an advertisement which appeared in the December 1979 issue of SIE — Sophisticated Investor, page 118, and of an article in the Western Law Journal, January/February 1980, page 1.*

### Assembly of Hope

*This organisation, appropriately located at One* Chapel Road, *Helmetta, N.J. makes an offer to the reader — at a* very *low cost — to become a Minister ($10) and/or to start one's own Church (also $10). The advantages are not small. Not only can one conduct "Holy Rites, Sacraments and Rituals... Advise, Treat, Inspire, Marry, Bury... Exorcise, Pardon, Bless...", BUT one benefits from tax exemption on a large scale. The advertisement gives a detailed example which we shall not reproduce here. It ends with the slogan* Become a Minister and start your own Church now! *The lower part of this full page ad. is a registration form to apply for one's "own personal ID card that will command instant recognition and respect for your new responsibilities".*

### Universal Life Church, Inc.

*This competing organisation is located at* Modesto, *California. Mr. Steve Goolian, a journalist, reports on it under the title:* How do you spell tax relief? — C-H-U-R-C-H. *One can, also for not more than $20, become a minister of this church provided that one "follows the church's only tenet: Do that which is right". Apparently, the promoters of this tax avoidance scheme think that it is right to set up a mail order system to sell their ministries for the purpose of avoiding tax. As one of the promoters according to Mr. Goolian has said — "a large market probably existed for such church-financial planning". Together with a friend he established his own "Church of Universal Harmony" which belongs to the Universal Life Church. They claim to have ordained "more than seven million" (!) ministers into the church.*

*This seems a good business at $20 each. No wonder the Internal Revenue Service are trying to stop this, unsuccessfully as they lost a case in 1973. "The IRS never appealed and refuses to say why", writes Mr. Goolian.*

*Indeed, there seems to be great reluctance to interpret such sections of the Internal Revenue Code as 107, 170 and 501 in a sense which would sustain their original spirit without introducing a new spiritual aspect. One may well wonder why other tax avoidance schemes are more easily contested (or, even, recognized as such) and whether in other countries tax (avoidance) and religious ideas would be so generously treated.*

*Over the years there have been serious discussions and fierce debates between priests on the question of whether it is ethical or moral to dodge taxes which are imposed on the basis of regular laws. As far as we know, the arguments used never included profit-making mail order schemes. In Mr. Goolian's article, the United States Commissioner of the Internal Revenue Service, Mr. Jerome Kurtz, is quoted as having said: "Those interested in protecting the preferences for churches must agree that the IRS has an obligation to be vigorous in stopping such schemes. The protection of church preferences requires that such preferences not be distorted". There will be few besides the promoters of new "ministers" and "churches", be they tax collectors or taxpayers, who will not wholeheartedly agree. On the other hand, one wonders whether all this is not a "mene tekel" in a world where more and more people are trying to get out of the increasing burden of taxes and other public charges. The many ways in which they do so show that they become desperate to a degree which is frightening. With regard to this "ultimate (tax) h(e)aven" the sky seems to be the limit...*

# Développements Fiscaux en Afrique

## Activités de la Commission Economique des Nations Unies pour l'Afrique

# Tax Developments in Africa

## Activities of the U.N. Economic Commission for Africa

J. van Hoorn Jr.

La Commission Economique des Nations Unies pour l'Afrique (C.E.A.) dont le siège se trouve à Addis Abéba avait déjà, en 1965, organisé une conférence fiscale à laquelle participaient des personnalités de haut rang appartenant à un grand nombre de pays africains. La réunion était bilingue (anglais et français) offrant ainsi, pour la première fois, la possibilité aux responsables fiscaux, anglophones ou francophones, de se rencontrer et d'être confrontés aux autres systèmes fiscaux et politiques de développement économique. La préoccupation principale de la conférence concernait la politique et l'administration fiscales. Des rapports nationaux servaient de base à la discussion.

Il est apparu au cours de cette réunion que l'on connaissait très peu des systèmes fiscaux nationaux des autres pays d'Afrique et que ce manque de connaissance et d'information n'était pas dû, du moins essentiellement, à une barrière linguistique. Il était intéressant de noter avec combien d'attention les participants écoutaient et discutaient les expériences de leurs collègues. Il n'est donc pas surprenant qu'il y ait eu un sentiment unanime en faveur d'une propagation d'informations concernant les développements fiscaux en Afrique.

La première conséquence de la conférence a été la demande, par la C.E.A., au Bureau International de Documentation Fiscale de rassembler une documentation complète sur la législation fiscale des pays d'Afrique. Le résultat a non seulement été la réunion unique, dans la bibliothèque, de matériaux classés systématiquement sur la quasi totalité de cet immense continent africain mais aussi la publication, par le Bureau, d'un ouvrage sur feuilles mobiles intitulé *Systèmes Fiscaux Africains*, accompagné de son édition parallèle en anglais: *African Tax Systems*; ces deux ouvrages étant régulièrement mis à jour. Ces ouvrages servent de base à une coopération plus profonde dans le contexte africain.

Au cours de la décade suivante, la C.E.A. a organisé d'autres conférences importantes ainsi qu'un grand nombre de cours et groupes de travail, certains couvrant une région ou une sub-région. L'un des résultats de ces activités a été la formulation d'un certain nombre de principes et d'obstacles liés à la participation sans cesse grandissante de l'Afrique dans l'économie mondiale. Ceci a même conduit à un projet non-officiel d'une convention multilatérale tendant à éviter les doubles impositions accompagnée de notes explicatives se rapportant aux différentes dispositions.

As early as 1965 the United Nations Economic Comission for Africa (E.C.A.), with headquarters in Addis Ababa, convened a tax conference in which top-ranking officials from a large group of African countries participated. The meeting was bilingual (English and French) and thus offered for the first time the possibility to English and French speaking tax officials of meeting each other and becoming acquainted with each other's tax systems and policies for economic development. The main emphasis was on tax policy and tax administration. Country reports served as a basis for discussion.

During the meeting it became apparent that little was known about national tax systems in other African countries and that this lack of knowledge and information was not, at least, not primarily, due to language barriers. It was interesting to note with how much attention the participants listened to and discussed the experiences of their colleagues. It is not surprising, therefore, that there was a unanimous feeling that more should be done to disseminate information concerning tax developments throughout Africa.

The first action undertaken by E.C.A. was to request the International Bureau of Fiscal Documentation to prepare a comprehensive documentation on the tax legislation of African countries. The result has been, not only that the Bureau's library contains a unique set of systematically arranged materials on practically every country in the huge African continent, but also that the Bureau published a large loose-leaf work under the title *African Tax Systems* with a parallel edition in French: *Systèmes Fiscaux Africains*, regularly updated. This work serves as the foundation for further cooperation within the African context.

In the following decade or so, E.C.A. organised other large conferences as well as numerous training courses and workshops, some of which covered a region or a sub-region. One of the results of these activities has been the formulation of a number of principles for, and pitfalls in connection with, Africa's increasing participation in the world economy. This even led to an unofficial draft for a multilateral tax treaty together with explanatory notes to the various provisions of it.

## LES ACTIVITES CONSULTATIVES ET DE RECHERCHE DE LA C.E.A.

Pendant de nombreuses années la C.E.A. a aidé des pays membres sous la forme d'envoi de missions consultatives et de conduite de groupes de travail locaux dans des domaines tels que *la politique, la législation et l'administration fiscales* aussi bien que celui de *la gestion budgétaire et financière* — tout ceci étant réalisé à la demande des états intéressés.

Les membres de la C.E.A. ont en outre effectué des études et rapports divers. Les études traitant de *l'utilisation des techniques d'imposition forfaitaire dans le régime fiscal des petits commerçants et des professionnels en Afrique* ainsi que *le contrôle des dépenses publiques* ont été entreprises récemment; les deux sujets présentent un intérêt tout particulier pour les pays en voie de développement.

La C.E.A. se penche spécialement sur le manque de possibilités de formation professionnelle et de recherche en Afrique. Actuellement, un projet sur la création et le développement de centres régionaux pour la formation professionnelle et la recherche en matière fiscale est en progrès. Ce projet est à mettre en parallèle avec des idées similaires qui ont cours dans d'autres parties du tiers-monde et surtout dans l'Asie du Sud-Est. Bien que l'assistance d'experts étrangers soit vraisemblablement nécessaire, du moins dans un premier stade, il est important de constater que des initiatives ont été prises dans des régions où les pays en voie de développement sont majoritaires et que le travail est tout d'abord entrepris par des experts locaux connaissant mieux que personne quels sont les problèmes posés dans des pays en voie de développement ayant une base culturelle souvent très particulière.

L'un des plus récents groupes de travail, traitant de la politique, législation et administration fiscales, a eu lieu en Eté 1979. A cette occasion les premières mesures ont été prises pour achever la création d'une association d'administrateurs fiscaux africains.

## L'ASSOCIATION D'ADMINISTRATEURS FISCAUX AFRICAINS

La réunion d'Addis Abéba a été suivie de celle de Février 1980 qui s'est tenue à Monrovia. La réunion inaugurale de l'A.A.F.A. a eu lieu dans cette ville en la présence du Ministre des Finances libérien, Son Excellence, l'Honorable Ellen Johnson-Sirleaf, et présidé par M. Philip T. Bowen, Secrétaire d'Etat pour les recettes du Libéria.

La Constitution de l'Association a été adoptée au cours de cette réunion; il a également été décidé que des comités sub-régionaux seraient établis comme suit:

*Afrique du Nord:* Algérie, Egypte, Jamahiriya Arabe Lybienne, Maroc, Soudan, Tunisie.

*Afrique de l'Ouest:* Bénin, Côte d'Ivoire, Gambie, Ghana, Guinée, Guinée-Bissau, Haute Volta, Libéria, Mali, Mauritanie,

## E.C.A.'S ADVISORY AND RESEARCH ACTIVITIES

For may years E.C.A. has been busy assisting member countries in the form of sending advisory missions and conducting local training workshops on such areas as *Tax Policy, Legislation and Administration* as well as on *Budgetary and Financial Management.* All this was done at the request of the countries involved.

In addition, E.C.A.'s staff carried on various studies and surveys. Recently, a start was made with studies on *Use of Presumptive Tax Assessment Techniques in Taxation of Small Traders and Professionals in Africa* and on *Expenditure Control,* both subjects which are of particular interest to developing countries.

E.C.A. is especially concerned about lack of training and research possibilities in Africa. Currently, a project on the creation and development of regional centres for tax training and research is in progress. This project runs parallel to similar ideas in other parts of the "Third World", above all, in South East Asia. Though assistance of outside experts is likely to be required, at least in the first stage, it is significant that initiatives are being taken within the regions where developing countries are in the majority and the work is to be primarily undertaken by indigenous experts who know better than anyone else what the problems in developing countries, with their often very special cultural background, are.

One of the most recent workshops, dealing with tax policy, legislation and administration, was conducted in the Summer of 1979. On that occasion, the first steps were taken to achieve the creation of an association of African tax administrators.

## ASSOCIATION OF AFRICAN TAX ADMINISTRATORS

The Addis Ababa meeting was followed up in Monrovia in February 1980. In this city the inaugural meeting of the A.A.T.A. took place in the presence of the Liberian Minister of Finance, Her Excellency, the Honourable Ellen Johnson-Sirleaf, and chaired by Mr. Philip T. Bowen, Deputy Minister for Revenues of Liberia.

During the meeting the Constitution of the Association was adopted. It was also decided that sub-regional committees be established as follows:

*North Africa:* Algeria, Egypt, Libyan Arab Jamahiriya, Morocco, Sudan, Tunisia.

*West Africa:* Benin, The Gambia, Ghana, Guinea, Guinea Bissau, Ivory Coast, Liberia, Mali, Mauritania, Niger, Nigeria, Senegal, Sier-

Niger, Nigéria, Sénégal, Sierra Léone, Togo.

*Afrique du Centre:* Angola, Cameroun, République Centrafricaine, Congo, Guinée Equatoriale, Gabon, Tchad, Zaïre.

*Afrique de l'Est:* Botswana, Comores, Djibouti, Ethiopie, Kenya, Lesotho, Madagascar, Malawi, Ile Maurice, Mozambique, Ouganda, Seychelles, Somalie, Swaziland, République Unie de Tanzanie, Zambie.

Il faut remarquer que la compisition de ces comités est fondée sur la situation géographique des pays et non pas linguistique.

Un Comité Exécutif provisoire a été nommé et comprend six membres, y compris les représentants des comités sub-régionaux. Le Président de l'Association est M. Bowen, son Vice-président M. Soulémane Abdoulaye, Directeur Général des Impôts au Togo.

Les membres de l'Association sont les pays membres de la Commission Economique des Nations Unies pour l'Afrique (C.E.A.) et de l'Organisation de l'Unité Africaine (O.U.A.). Chaque membre a droit à un vote mais est représenté par 2 personnes désignées par le Ministre des Finances. L'Association sera financée par les contributions des pays membres en fonction de leur capacité économique avec un minimum de 0,5 pour cent et un maximum de 10 pour cent; il a été décidé d'adopter l'index de l'O.U.A. à cet effet.

## PROGRAMME DE L'ASSOCIATION

Les sujets suivants ont été retenus pour être étudiés à la réunion de l'Assemblée Générale qui aura lieu en Février 1982:
- Evasion et fraude fiscale
- Information sur la conscience fiscale
- Fiscalité et développement
- Techniques de législation fiscale
- Amélioration et consolidation de l'organisation et gestion fiscales.

On s'est par ailleurs mis d'accord sur le fait que les comités sub-régionaux établiraient leur propre programme et que chaque comité organiserait au moins un cours de formation professionnelle ou un séminaire en 1981.

L'Assemblée Générale [1] a accepté de demander à la C.E.A. de préparer à la demande de l'Association une liste des experts fiscaux africains. L'Assemblée Générale a également demandé à l'E.C.A. "d'écrire aux pays membres pour que ceux-ci soumettent régulièrement des copies de leurs codes fiscaux au Bureau International de Documentation Fiscale à Amsterdam". [2]

1. D'après l'article 20 de la constitution, ce document entrera en vigueur dès que 10 pays auront accepté d'être membre et signé la constitution. Ceci ayant été le cas, l'Assemblée Générale de l'Association a été déclarée établie.
2. Rapport de la Réunion Inaugurale de l'Association des Administrateurs Fiscaux Africains et d'un Groupe de travail sur la politique, la législation et l'administration fiscales, Monrovia 11-19 Février 1980, Para. 26, p. 8.

ra Leone, Togo, Upper Volta.

*Central Africa:* Angola, Cameroon, Rep. of Central Africa, Congo, Equatorial Guinea, Gabon, Chad, Zaire.

*East Africa:* Botswana, Comoros, Djibouti, Ethiopia, Kenya, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Seychelles, Somalia, Swaziland, Tanzania United Republic, Uganda, Zambia.

It is worth noting that the composition of these committees is based upon the geographical situation of the countries and not at all on language.

A provisional Executive Committee was nominated consisting of six members including representatives of the sub-regional committees. The chairman of the Association is Mr. Bowen, its vice-chairman Mr. Soulémane Abdoulaye, Director-General of Taxation of Togo.

The Association's members are the countries which are members of the U.N. Economic Commission for Africa (E.C.A.) and of the Organisation of African Unity (O.A.U.). Each member has one vote but is represented by two persons designated by the Minister of Finance. The Association is financed by contributions from the member countries established according to their economic capability with a minimum of 0.5 and a maximum of 10 percent; it was decided to adopt the O.A.U. index for this purpose.

## PROGRAMME OF THE ASSOCIATION

The following subjects were selected for discussion in the General Assembly meeting to be held in February, 1982:
- Tax fraud and evasion
- Information on tax awareness
- Taxation and development
- Techniques of tax legislation
- Improvement and strengthening of tax organisation and management.

Furthermore it was agreed that the sub-regional committees should draw up their own programme and that each committee should organise at least one training course or seminar in 1981.

The General Assembly [1] agreed to request the E.C.A. to prepare on behalf of the Association a roster of qualified African tax experts. The General Assembly also "requested E.C.A. to write to member countries to submit copies of their tax codes to the International Bureau of Fiscal Documentation in Amsterdam on a regular basis". [2]

1. According to Article 20 of the Constitution, this document becomes effective as soon as ten countries have accepted membership and signed the Constitution. This being the case, the General Assembly of the Association was declared established.
2. Draft Report of the Inaugural Meeting of the Association of African Tax Administrators and a Workshop on Tax Policy, Legislation and Administration, Monrovia, 11-19 February 1980, Para. 26 at p. 8.

## GROUPE DE TRAVAIL SUR LA POLITIQUE, LA LEGISLATION ET L'ADMINISTRATION FISCALES

A l'occasion de la création de l'Association des Administrateurs Fiscaux Africains, un group de travail s'est penché sur cette matière. Six sujets principaux ont été discuté à Monrovia, à savoir:

(i) imposition des sociétés multinationales et transnationales;
(ii) les causes de la double imposition internationale et les mesures pouvant l'éviter;
(iii) directives pour la négociation de conventions tendant à éviter les doubles impositions, avec une référence particulière au modèle de conventions de double imposition entre les pays en voie de développement d'Afrique et les gouvernements des pays du siège des investisseurs étrangers;
(iv) le régime fiscal du secteur agricole avec une référence particulière aux pays africains en voie de développement;
(v) planification de réforme fiscale; et
(vi) considérations essentielles liées à l'organisation et à la gestion des Sections responsables de l'Impôt sur le revenu.

Le document mentionné à la note 2 reprend certains points des discussions rapportées comme ayant été conduites à un haut niveau permettant "au groupe de travail de reconnaître les points essentiels et atteindre une majorité d'opinion sur des solutions proposées ou soumettre ultérieurement à l'étude certains de ces points". [3] Le manque de place ne nous permet pas de donner ici plus d'informations. Les personnes intéressées peuvent demander (gratuitement) une copie du résumé préparé par la C.E.A. sur ses sujets.

> **NOTE:**
> Le *Bulletin* a déjà rapporté, dans le passé, des développements fiscaux ayant eu lieu dans un grand nombre de pays, y compris différentes parties du monde en voie de développement. Ces rapports contiennent des informations sur des activités exercéès par des organisations internationales.
>
> La Rédaction a l'intention de publier régulièrement des rapports sur ces organisations afin de permettre à la communauté fiscale internationale d'être systématiquement informée de l'actualité.

3. Rapport (note 2, supra), appendice rose, p. 1.

## WORKSHOP ON TAX POLICY, LEGISLATION AND ADMINISTRATION

On the occasion of the creation of the Association of African Tax Administrators, a workshop was conducted under this title. Six main topics were discussed in Monrovia, viz.:

(i) Taxation of multinational and transnational corporations;
(ii) The reason for international double taxation and measures for its avoidance;
(iii) Guidelines for negotiation of tax treaties especially with reference to the model on double taxation treaties between African developing countries and the governments of foreign investors' home countries;
(iv) Taxation of agricultural sector especially with reference to African developing countries;
(v) Tax reform planning; and
(vi) Vital considerations involved in organization and management of Income Tax Departments.

The document referred to in note 2, contains a review of the discussions which are reported as having been conducted at a high level enabling " the workshop to identify major issues and to reach a consensus of opinion on solutions or further consideration to be given to these issues". [3] Space limitations prevent the giving of details here. Those interested are invited to request (free of charge) a photocopy of the summary prepared by E.C.A. on these subjects.

> **NOTE:**
> In the past, the *Bulletin* reported on tax developments in a large number of countries, also in various parts of the developing world. These reports included information on activities carried on by international organisations.
>
> It is the intention of the Editors to publish reports on these organisations on a regular basis so as to keep the international tax community systematically informed on what is going on.

3. Draft Report (note 2, supra), pink appendix, p. 1.

# The Commonwealth Association of Tax Administrators (C.A.T.A.)

## TECHNICAL MEETING ON THE COLLECTION OF TAXES AND TRAINING OF COLLECTION PERSONNEL

Elsewhere in this issue mention is made of the establishment of the Association of African Tax Administrators earlier this year. In several respects it was modelled on another intergovernmental organisation established as long ago as 1967: CIAT – the Interamerican Centre of Tax Administrators, with headquarters in Panama City.

C.A.T.A. is an organisation of a similar nature, but it is not restricted to a specific region or continent. It was conceived in 1976 and was formalized by a constitution adopted in 1978. C.A.T.A., with headquarters in London, England, currently links the tax administrators in 31 Commonwealth states and dependencies. They are: Australia - Bahamas - Bangladesh - Barbados - Botswana - Canada - Cook Islands - Cyprus - Fiji - The Gambia - Ghana - Grenada - India - Jamaica - Kenya - Malawi - Malaysia - Malta - Mauritius - New Zealand - Nigeria - Papua New Guinea - Singapore - Sri Lanka - Swaziland - Tanzania - Tonga - Trinidad & Tobago - United Kingdom - Western Samoa - Zambia.

The basic objective of C.A.T.A. is to promote the improvement of tax administration in all its aspects within the Commonwealth with particular emphasis on developing countries. This is accomplished by promoting the improvement of tax administration of members through the exchange of experiences and the dissemination of information and technical knowledge. In complying with these objectives, C.A.T.A. periodically convenes conferences on specific aspects of tax administration and holds a triennial general meeting in which its members participate.

From April 14 to 18, 1980 a Technical Meeting of C.A.T.A. took place in Swaziland. It was attended by tax officials of the rank of Commissioner or Deputy-Commissioner of the following 19 countries: Bangladesh, Botswana, Canada, Cook Islands, Cyprus, Jamaica, Kenya, Malawi, Malaysia, New Zealand, Nigeria, Papua New Guinea, Sierra Leone, Sri Lanka, Swaziland, Tanzania, United Kingdom, Western Samoa and Zambia.

Responsible for coordinating this Technical Meeting was Mr. W.A. Stoneham from Canada.

The following is a report of the proceedings of this Technical Meeting.

The second technical meeting of C.A.T.A. member states took place at the Yen San Hotel in Mbabane, Swaziland during the week of April 14 to April 18, 1980. The meeting was hosted by the Kingdom of Swaziland and the technical co-ordination for content as well as conduct of the proceedings was the responsibility of the Canadian delegation.

In order to identify areas of primary concern to the member countries intending to participate in the conference, all members were asked several months prior to the meeting to submit papers covering the following 3 aspects:

1. The most serious problems affecting collection of taxes in their country.
2. Details on any formalized tax collection training program administered by them.
3. Description of any significant strengths in their system which provide assistance in the collection of taxes.

From the submissions received from 19 of the member-countries, seven major areas were identified as being of interest to all.

These main topics were each addressed by 1 or 2 speakers in terms of how these matters affect the tax collection operation in their country and how their respective administrations handle them. The presentations were followed by either workshops or round table discussions, which expanded these topics or aspects thereof, as they applied to the other countries represented at the conference. Topics of slightly lesser importance although of considerable interest to all were allocated to the last day of the conference for round table discussions. Time permitting, the round table discussions were to be extended to any other topics raised from the conference floor. All conference participants were informed in advance of all the agenda topics selected and were requested to come prepared to contribute to the workshop and round table discussions.

The conference opened on schedule on the morning of April 14 with 33 delegates from 18 countries in attendance. After the opening exercises, Mr. J.A.R. Felix, Commissioner General of Inland Revenue,

Mr. W.A. STONEHAM

Mr. Stoneham joined the Canadian Department of National Revenue, Taxation in 1965 following a career in the private sector and presently is the Assistant Director, Policy and Enforcement, Accounting and Collections Division.

Sri Lanka addressed the conference on the first topic: Tax Delinquency: Causes and effects today; setting out the theme and indeed the principal reasons for which this conference of Commonwealth Tax Administrators had been convened.

### I. Tax delinquency: Causes and effects today

In his opening remarks the speaker stressed the importance for every government of building public confidence in its programs in general and its ability to collect taxes to finance such programs as an important factor in curbing tax delinquency.

Mr. Felix broke down the problem of tax delinquency into three different areas:

a. under reporting of income and tax,
b. non-reporting of income,
c. non-payment of tax on declared or assessed income,

indicating that all three are a direct result of the public attitude toward compliance and that the latter is influenced by such items as:

1. Fairness of the tax system.
2. Fairness and impartiality of administration.
3. Efficiency and thoroughness of tax administration.
4. Chances of delinquency being detected.
5. Severity of penal action upon detection and frequency of application of penal action.
6. The taxpayer's confidence in and loyalty to the Government and his sense of duty to pay the correct amount of tax.
7. Degree of taxpayer's understanding of his duties and obligations.
8. Degree of public information available to create tax consciousness.
9. Number of administrative measures used to withhold tax at source such as on dividends, interest, and employment earnings.
10. "Red tape" and physical difficulties involved in making payments.

Mr. Felix further referred to the effect of economic conditions such as: Commercial interest rates being substantially higher than penalty payable for non-payment, lack of cash-flow in a stagnant economy, government policies which adversely affect taxpayer's sources of income and lack of or slowness in compensation, and payment of prior year taxes out of current income subject to current economic influences.

He recommended that tax administrators orchestrate legislation and procedures beginning with preventative aspects like withholding taxes and ending with an arsenal of legal sanctions to encourage compliance in filing returns and paying taxes assessed. Publicity via all available media should be used to indoctrinate taxpayers with such requirements and the possible consequences of not complying.

The speaker advocated the use of Electronic Data Processing equipment as an effective means to identify and categorize nonfilers as well as to provide an up-to-date collection accounting system, which would allow early compliance action and thus serve to create a better tax consciousness by dispelling public lethargy in this area. Additionally he recommended publicity seminars and consultations with tax practitioners to clarify apparent difficulties in public understanding of certain complicated taxing provisions.

Mr. Felix cited the intelligent use of estimated assessments, of tax clearances as well as the acceptance of arrangements from taxpayers to pay their tax arrears over a period of time in line with their verified ability to pay, as useful compliance tools. He emphasized the importance of controlling tax delinquency in regard to the nations's economy by relating delay in collection to increased losses to the the government treasury which in turn result into greater budget deficits and increased government borrowing. Tax delinquency further has an inflationary effect in that these tax monies, not available to the Treasury, are being diverted to purchase of consumer goods. This further creates serious inequities for the compliant taxpayer, who, besides not having their tax money to spend are carrying the total tax burden, while the tax evaders enjoy all the benefits provided by the state without paying their share.

In subsequent round table discussions the plenary expressed general agreement with Mr. Felix's observations. On the topics of tax amnesty and tax clearances raised, there appeared to be agreement on the former's overall negative effect and that it thus is rarely used, while the latter procedure is used selectively by many member countries with good results. Further, while there are presently few or no tax collection treaties in existence, substantial compliance benefits were envisioned by the delegates from the existance of such treaties in the future.

### II. The Department's collection organization, the purpose, the activities and the relation with other work areas of the Revenue Department

Two papers were presented on this topic, the first by Mrs. Eugene Heather, Technical Officer, Inland Revenue Department, Western Samoa, and the second by Mr. M.U. Ahmad, First Secretary (Taxes) National Board of Revenue of the People's Republic of Bangladesh.

The organizational structure of the Samoan Revenue Department provided for a distinctly separate Collection (or Accounts) Section responsible for the collection and collection accounting functions only. The section's staff is supplemented periodically by assessing staff to provide extra manpower for ledger balancing exercises, etc. but in all other aspects the two functions are totally separate.

This contrasted sharply with the approach taken by the National Revenue Board of Bangladesh which has combined the assessment and collection recovery functions under the Deputy Commissioner of Taxes (formerly Income Tax Officer). While separation of these two functions has been recommended staffing constraints up to this point have not allowed such separation.

Subsequent discussions by the plenary indicated that the majority of delegates favoured a separate collection function for better results. Instances of close cooperation by both audit and collection sections in exacting payment of taxes assessed at time of assessment or shortly thereafter were illustrated by two of the member states. This pertained especially to situations where prompt action appeared necessary to avoid losses. In the subsequent workshops the three groups arrived at the following observations and recommendations:

Separating collections from other functions provides the following advantages:

1. Better collection results due to greater concentration of effort in a single area.
2. Staff obtains greater in-depth knowledge of collection procedures.
3. Speedier recovery of delinquent taxes reducing likelihood of potential losses.
4. Less likelihood of employee becoming susceptible to offers for collusion.
5. Less training time required to make employee effective in one function.
6. Staff will progress from handling simple accounts to handling more complex accounts with additional experience and training.
7. This sytem still allows for rotation of staff into other areas such as assessing and audit to provide opportunities for career development and job satisfaction.

The integrated system (staff working in 2 or more functions simultaneously) also has certain advantages:

1. Provides greater all round experience and knowledge to staff.
2. Permits rapid shifting of staff resources into areas of greatest need.
3. Staff has a better overview of the entire operation, resulting in less unproductive work. (e.g. assessments which are uncollectible at time of assessment etc.)
4. May provide greater job satisfaction and opportunity for promotion.

The consensus appeared to lean toward the non-integrated approach with provision for staff rotation, as being the most desirable, although many of the participants operated under an integrated system.

### III. Enforced collection of delinquent taxes, judicial vs. administrative procedures

This topic was addressed by the delegates of 2 countries Mr. J.B. Sweeting, Director, Collection Procedures, of the Board of Inland Revenue for the United Kingdom, and Mr. H.W. Ramien, programs officer, Accounting and Collections Division, Revenue Canada.

Mr. Sweeting after briefly outlining the responsibility areas of the Inland Revenue Department in respect to the collection of all direct taxes on income and capital as well as the National Insurance contributions, indicated that all enforced collection work is initiated in the 250 local collection offices under the supervision of the local Collector in Charge. Their collectors most frequently use the administrative distraint procedure, available under authority of the tax statute, which permits seizure and sale of goods of the defaulter. The simple initiation of this process is in the majority of cases sufficient to motivate delinquent taxpayers to comply (in 1979 only .2 percent of all distraint calls resulted into eventual sale of assets). Care and discretion is utilized in the application of this procedure to avoid potential abuse.

Mr. Sweeting then referred to the judicial processes available. Depending on the amount of the tax debt, the Department uses the Magistrate's Court or County Court, with only debts over £2000 being brought before the High Court. The courts upon granting judgement can provide enforcement instruments for seizure of goods and monies, as well as such measures as enforced as bankruptcy or liquidation. The only disadvantage to these processes arises from the invariable delays encountered in the two higher courts.

The speaker stated, that these processes, coupled with department's policy of collecting taxes promptly, with the least amount of friction and through efficient use of personal visits and telephone calls has brought good results.

Canada also uses administrative procedures extensively, with its collectors issuing Demands on Third Parties under authority of the Income Tax Act to intercept incomes or seize bank accounts of the defaulting taxpayer. If this procedure proves ineffective, Mr. Ramien stated that Senior Head Office officials can issue a certificate under the Act which upon registration in the Federal Court of Canada has the same force and effect as a judgement. Based on this certificate writs and other enforcement instruments to seize and sell goods, lands as well as monies and securities can be obtained promptly.

Another provision under the Act allows the Canadian Income Tax Department to assess and collect from a transferred spouse the tax owing by the transferror spouse up to the value of the property transferred. The transferree is subject to all collection actions possible under the Act.

The speaker emphasized that there is a constant awareness by management and staff of the formidable extent of these available powers and that continual guidance and control is exercised by supervisory and management staff to prevent any possible abuse of these powers.

In the subsequent workshops the delegates selected the following administrative provisions as particularly successful and desirable:

1. Interest and penalty provisions.
2. Instalment provisions.
3. Withholding provisions on income from employment, dividends, royalties, and any other sources possible.
4. Interception or attachment of incomes and bank accounts.
5. Tax clearance certificates for individuals leaving the country or other specific situations.
6. Distraint procedures.
7. Right to offset tax refunds against prior year tax debts.
8. Right to offset funds payable by other Crown Departments to the delinquent taxpayer.
9. Making directors and managers of companies personally responsible for company tax arrears.

The need for judicial processes would still exist, but with most or all the provisions above adapted where necessary to the particular needs of each country, the frequency for using such judicial processes would be considerably reduced.

## IV. Identification of training needs and the design and implementation of a training package to meet those needs

Mr. R. Adair, District Commissioner of the Department of Inland Revenue for New Zealand provided the delegates with an overview on how his Department came to develop its present comprehensive Training Program.

He commenced with an outline of the qualities required in senior revenue staff, such as the need to be effective communicators, the ability to interpret complex legislation competently, as well as being well versed in accounting and commercial practices. Additionally they must have the capacity to adapt to continually changing conditions.

Training, therefore, is considered an ongoing process, and must be geared to the employees present duties as well as toward potential future management positions.

A major review of his Department's training system in 1970 revealed that training at the district level was dependent on the degree of enthusiasm of local management and that it varied considerably between offices. Planned programs were often discontinued due to workloads or if training was given it was frequently poorly prepared. The review committee also recognized the need for finding or developing replacements for the majority of senior managers over the next decade and that well coordinated training plans were needed to accomplish this.

These findings resulted in establishment of the centralized Staff Training Council comprised of the Department's senior functional managers. This council approves the National Training Program, as well as the priorities for all courses, both district and centralized, including all financial and other requirements for the latter.

The council is assisted by the Head Office Training Section, which is responsible for conducting centralized courses as well as the evaluation of training results nationwide and the review of course content, as well as the maintenance of up-to-date personal training records for all staff.

Mr. Adair stated that district office level training is conducted by a local Staff Training Officer who spends at least 60 percent of his time in this function and is usually in this function for a 2 year period. The districts are further provided with programmed learning training manuals and centralized courses are made available to the district office staff.

The speaker emphasized that training programs must be continuously evaluated in order that they can meet the needs of both staff and management, and he suggested that this be done, by having employee and management evaluate the course material and the employee's performance respectively on an on-going basis. Only constant involvement by management in providing feed-back on how the training measures up to what they want or expect from the program, will ensure the success of such programs.

In discussions following his presentation Mr. Adair indicated that his department uses the employee's overall performance and competence as recorded in the annual performance review together with related work experience as a basis for promotion. He also indicated that in his opinion the fully trained employees leaving the department for the private sector may actually benefit the department in the long run by promoting better communications with the private sector.

From the workshop groups, the following observations and recommendations were raised:

1. Specialized training for collection officers was with few exceptions deficient or non-existent. Generally such training consisted of on-the-job training only.
2. The groups agreed on the need for strong support from top management for training programs. Such programs should be centrally controlled and directed to ensure uniform application of the law country-wide.
3. Smaller countries, in as far as their different systems allowed, might pool their resources and set-up a central training facility.

## V. Initial collection procedures

Mr. Charles Mwangi, Principal Collector of Income Taxes for Kenya addressed this topic, giving considerable background on the manual accounting procedures employed by his department.

He indicated that one central collection office collects all assessments raised in

Kenya's 9 Assessing Districts. After assessments are outstanding beyond the due date and no payment is received, penalty and interest are added to the amount and an Overdue Notice is sent to the taxpayer requesting the total amount by a specific date. If the taxpayer agains fails to pay, enforced collection action is commenced after the due date has elapsed. The only exception arises in cases where the taxpayer appeals and the responsible assessor issues a "Stand Over Order". In such cases collection action ceases until the appeal has been dealt with.

In the subsequent round table discussions various procedures were brought out by the delegates, ranging from a series of notices and letters issued either manually or by computers, the use of telephones, as well as the use of partial payment procedures controlled by collection personnel or computers. Although there appeared to be a great variance in procedures, it was felt that an efficient approach at this early stage can eliminate many future collection enforcement problems.

### VI. Publicity programs, a means of raising the public's social conscience and of promoting taxpayer education in an effort to encourage compliance with the law

Mr. W.A. Stoneham, Assistant Director, Enforcement and Policy, Accounting and Collections Division, Revenue Canada, presented this topic.

In an effort to make the public aware of the taxation process and to gain the public's confidence and voluntary compliance Mr. Stoneham referred the delegates to Canadian Taxpayer Education Programs, such as the "Teaching Taxes" manual used in schools, as well as to taxpayer assistance programs implemented through public relations officers, toll-free telephone service available to taxpayers for assessing inquiries, the issuance of Tax Information Pamphlets, as well as the ongoing serialized publications such as the Interpretation Bulletins, Information Circulars and Income Tax Rulings.

The foregoing provides the general public and especially the tax practitioners in the private sector with essentially the same large body of technical and practical information on departmental interpretations and procedures, as is available to Departmental staff. Revenue Canada further trains community volunteers to assist taxpayers who are in any way incapacitated to file their own returns.

These programs, coupled with periodic media campaigns and a limited number of high quality films shown in movie-houses across Canada have achieved an effective two-way communication between the Department and the public. The resultant confidence of the taxpayers in the fairness of the tax system is reflected in the highest degree of voluntary compliance which exists in Canada today.

In discussions following the delegates agreed with Mr. Stoneham that under the self-assessment system more information must be made available to the public to gain the desirable degree of compliance. At the same time, they agreed that certain procedural processes or information contained in internal manuals on assessment or write-off procedures must not be made public.

The workshops' objectives on Publicity efforts and methodologies to be used to support such effort were, on the delegates' request, expanded to also include recommendations in regard to implementation of training programs.

The workshop findings and recommendations on the publicity objectives were as follows:

1. Publicity on the role and purpose of the tax department, to create better public understanding of its role, is essential to reducing the Department's administrative workload.
2. Publicity efforts should be directed at school children in progressive steps to generate an early understanding of taxation and the creation of a future tax conscience. Children in turn can also educate their parents in tax matters.
3. Mass media such as Radio, T.V., newspapers and publications as well as public speakers should be used to provide publicity on the Department's programs, including filing and payment and instalment requirements etc.
4. Public Relations Officers should be trained and used to provide information to the press on high-profile situations creating positive publicity for the Department. (Investigations, prosecutions, interviews on filing of returns etc.)
5. In remote areas politicians or other individuals such as chiefs of tribal councils etc. could be used to provide basic tax information to the populace in their area.
6. Departmental staff must display proper conduct at all times, must be courteous and well groomed, and their mode of living must be exemplary as often a single employee forms the taxpayer's concept of what the tax department is like.
7. Use of questionnaires was advocated to obtain feed-back from the public on what areas, of interest to them, were not sufficiently covered by existing publications.
8. The delegates advocated the use of simple language in all publications aimed at the general public.
9. One country is in the process of creating a central one-stop centre providing information on all government services, which will include the tax department.
10. It was suggested that C.A.T.A. should assist on the technical side in the creation of a film which would highlight the various positive aspects of taxation, and which could be distributed to C.A.T.A. member countries for public showings.
11. During peak seasons temporary offices can be set up to provide public information to taxpayers in their home areas.

The workshop findings on the Establishment of Training Programs provided the following:

1. There is, in the majority of member countries, a distinct lack of resources for training programs, especially for collection personnel.
2. To alleviate this condition, it was suggested that the countries pool their resources, and attempt to standardize their training programs to the extent possible. The delegates further recommended that central training centres should be created under the auspices of C.A.T.A. where all general training is given to staff of participating members.
3. If financial restraint did not permit sending all the staff to such a centre, senior personnel should be sent, who upon their return home, could pass this training on to more junior staff and at the same time amend it as necessary for local conditions.
4. It was suggested that C.A.T.A. set up a systematic training program for training senior collection personnel, and that this course be periodically improved on the basis of evaluation questionnaires completed by course participants.
5. If the foregoing suggestion was not feasible, C.A.T.A. could prepare a general staff training manual for use by member countries, which could be adapted to local requirements.
6. Lack of training in enforcement procedures and especially court action constitutes a serious problem in a number of the member countries.

There was consensus among the delegates that while training presented a considerable expense, it nevertheless also presented the key to succcessful execution of the departmental programs. The long term benefits derived, therefore, return value worth many times the expense incurred in training staff.

Similarly, it was felt that, if the taxpaying public gains a better understanding of the role of the tax department in relation to the nation's economy, and each taxpayer becomes aware of, or can be made to feel part of, a nationwide effort to create or maintain a country in which he can be happy and proud to live, the effort and expense of publicity programs is returned many-fold.

## VII. Policies and procedures dealing with the deletion of uncollectible debts and small accounts

Presentations on this topic were given by Mr. S. Sivalingam, Deputy Director General Department of Inland Revenue, Malaysia and Mr. H.W. Ramien, Programs Officer, Accounting and Collections Division, Revenue Canada.

Mr. Sivalingam emphasized the importance of tax administrators examining the causes for write-offs and taking steps to eliminate such uncollectible amounts promptly from the Department's Receivables.

He detailed various causes for accounts becoming uncollectible among them extended payment arrangments, poor collection follow-up, unrealistic estimated assessments and disappearance of taxpayer's assets, and he stated that his Department's policy of reviewing uncollectibles with a view toward improving its policies and procedures has been effective and has resulted into only a fraction of 1 percent of the taxes assessed being written off.

While both remission and write-off procedures are available to delete assessed amounts very few situations qualify for the former and the majority of deletions takes place in the form of Write-off of Irrecoverable Tax in accordance with General Treasury Instructions.

Once it can be proven that all reasonable attempts for recovery have been made and the balance cannot be collected and there is no evidence of departmental negligence, the accounts so identified are submitted to the Secretary-General Treasury with full explanation for write-off approval. Upon approval the accounts are deleted from the ledger.

Canada while using very similar criteria uses its computer facilities to remove accounts of nominal size and accounts with poor collection potential from the collector's workload. These accounts are monitored by computer for several years and any activity such as returns filed, changes of address or refunds becoming available will either return these accounts to the collector or will result into refunds being offset or both. In cases of continued inactivity for several years the accounts will eventually be written off.

Accounts qualifying for write-off either after having gone through the foregoing procedure or meeting pre-set write-off criteria are reviewed by a committee of Senior Head Office and District Office officials, who will approve or reject such accounts based on the facts provided. This committee also examines the accounts to determine whether they are uncollectible because of particular departmental programs or procedures.

The write-offs are finally examined and approved at 3 different levels depending on amounts, ranging from the Minister to Treasury Board or Parliament, and only after such final approval are they deleted from the ledger.

In the subsequent round table discussion all delegates agreed on the importance of removing uncollectible accounts from the Department's receivable ledger as soon as their uncollectibility is established, so that Revenue receivables are reflected realistically.

The Plenary raised the point that the amount of work required to substantiate a write-off often discourages staff, who will rather turn their attention to accounts which can still be collected.

Artbitrary (provisional) assessments were cited as a frequent cause for write-off, with the assessments often being unreasonably high and for that reason being impossible to collect. The delegates favoured New Zealand's approach which requires their assessors to substantiate all default assessments as being reasonable.

Several delegates indicated that their departments wrote off the tax balance only, and simply reversed interest and penalty.

The round table discussions following the final presentation were subject to close time constraints and resulted into the comments and recommendations recorded below on the following topics.

1. *Appeals and the effect on collection*

This presented a problem in several, if not most, of the member-countries. While many of the tax statutes required payment in full despite any appeal or objection, in many cases collection action on the amount under dispute was curtailed. This delay in collection in some countries increased the total taxes outstanding considerably and resulted into losses to Treasury when such amounts became irrecoverable because of changes in the taxpayer's financial circumstances. The Canadian approach of requiring the taxpayer appealing his assessment to pledge realizeable security in lieu of payment, was noted with some interest as an alternative which could eliminate such losses.

2. *Ways and means of improving compliance in remote areas*

The delegates advocated the use of radio programs to improve public understanding and acceptance of taxation.

Some countries indicated that setting up local workshops or group discussions, as well as training classes on basic business procedures and bookeeping has had a positive impact, but that it was a slow process to change the population's generally negative attitude in regard to taxation.

Requiring tax clearances for renewal of business licenses, administered locally by village leaders or police, has resulted into improved compliance in several countries.

3. *Recruitment and retention of trained collection personnel*

The consensus was that it was difficult to attract personnel to the collection function, as the career possibilities are relatively narrow within this area. To improve this, the delegates recommended that rotation into other areas should be made available to the staff. Also an appropriate payscale must exist for collectors' jobs to attract individuals with the proper motivation and personality. Such individuals must be self-motivated, conscientious and resourceful in performing their duties. The delegates agreed on the importance of providing the employees with a detailed job description, to ensure they are aware of the scope of their duties, and also to allow proper evaluation of their performance by management.

Discussion arose on the aspect of evaluation and the various approaches used, which varied from "on-the-job" praise or criticism to self-assessment by an employee of his performance with subsequent in-depth discussion with supervisor of specific performance areas, as well as the employee's future aspirations and potential for advancement. In the latter procedure the results are recorded and are reviewed by different levels of management to identify potential candidates for future senior position.

Several countries indicated, that much time and resources had been allocated to the development of an efficient system of staff evaluations, as the latter constitutes an important factor in motivating staff, providing specific training, as well as identifying future potential which can be developed to the administration's and the employee's benefit.

4. *Computer application to tax collection*

It was pointed out by the delegates of countries using computers on a larger scale, that computers do not present the solution to all problems. They stated that a computer system must be preceded by an effective manual system, which can then be adapted. A number of member-countries are presently using computers and have done so for some time, others (a total of 12 countries) are in the process of setting up taxpayer master records, accounts receivable and other accounting processes, with such programs as the issuance of assessments and initial collection follow-up procedures to follow at a later state.

Several of the countries indicated difficulties in developing such programs, and it was suggested that in order to develop a system which will meet the needs for a particular administration, it is essential that the administration's management be well versed in the systems area. Only with such knowledge can the "computer people" be directed into developing programs and systems which will effectively handle specific functions and procedures.

**Kailash C. Khanna:**

# INDIAN BUDGET 1980/81

Expectations of a major corrective exercise in the direct tax structure were built around the Indian Budget for the year 1980/81, particularly because in the immediately preceding year there had been an estimated drop of 3 percent in GNP at 1970/71 prices, a rise in the price level of about 16.8 percent and a general deceleration in industrial capacity utilisation with an expected cost escalation. Regrettably, the Finance Minister, Mr. Venkataraman, has suggested only minor adjustments with crumbs of tax relief thrown here and there. The surcharge on personal income-tax will be reduced from 20 to 10 percent, thereby lowering the maximum marginal rate from 72 to 66 percent. The tax benefit will be insignificant having regard to the prevalent inflation. The eminent Jurist, and until recently India's Ambassador to the United States of America, Mr. N.A. Palkhivala, has strongly advocated indexation of the tax rates to counter inflationary trends.

In the sphere of corporate taxation, the Finance Minister has suggested a continuance of the "tax holiday" with a change in the basis of computation of the taxable income. In the case of companies, 25 percent of the taxable income derived from a new industrial undertaking will be exempt from tax for a period of seven years. However, in computing the quantum of "tax holiday" profits, the losses, depreciation and investment allowance of earlier years in respect of the new industrial undertaking will be taken into account even though these might have been set off against the profits of the taxpayer from other sources. The Finance Minister's reasoning for the proposed change is that the existing "tax holiday" benefit favours capital intensive industry whereas the need is to stimulate investment in labour intensive industry. The proposed quantum of tax-free profits is lower than the existing benefit, and it may not be feasible for a new undertaking to earn adequate profits in its formative years. There is no provision for carry forward of the unabsorbed tax benefit and in many cases the proposed "tax holiday" may be a still-born incentive. It has been suggested that the percentage figure should be raised to 45 and the holiday period extended to ten years.

An otherwise innocuous Budget, it has generated considerable heat and controversy because of suggested retroactive changes in legislation especially in two areas of importance to the corporate sector, a short reference to which has been made in paragraph 85 of the Budget speech. The existing "tax holiday" profits are determined with reference to the capital employed. In 1972 the Central Board of Direct Taxes notified a rule saying that borrowed funds would not be included in the computation of capital employed. The taxpayers contended that since the Income-tax Act used the words "capital employed" without any restriction or limitation, the expression must be understood in its general or commercial sense and that the exclusion of borrowed funds from capital through a notification was beyond the rule-making powers of the Central Board. Several High Courts have decided in favour of the taxpayer. In order to nullify the effect of the Court rulings, the Finance Minister has suggested an amendment of law with retroactive effect as of the year 1972. Another proposal seeks to give retroactive effect as of the year 1968/69 to a change in law to counter a ruling of the Supreme Court. Under an existing provision, barring few cases, 60 percent of intercorporate dividend income is exempt from tax. The relevant provision states that where a domestic company receives "any income by way of dividends", a deduction of 60 percent shall be allowed from such income. Taxpayers contended that the deduction of 60 percent should be calculated with reference to the gross income from dividends and not the net. To clarify, if a company received a dividend of 100 it would straightaway deduct therefrom 60, leaving a dividend income of 40, from which it would further deduct expenses, interest and bank charges, if any, and pay tax only on the balance. The tax authorities, on the other hand, argued that the deduction of 60 percent should be calculated with reference to the net dividend income arrived at after subtracting interest and expenses from the total dividend received. The matter was taken up to the Supreme Court which held that the expression "income by way of dividends" described only the nature of the income and did not relate to the quantification thereof. In order to negate the effect of the Supreme Court's judgement, the Finance Minister has now proposed retroactive legislation stretching back to the year 1968/69.

Chambers of Commerce and other associate bodies have strongly represented against the proposed retroactive amendments on the ground that these are unethical and against the generally accepted principle of retroactive legislation; moreover, these will detract from the sanctity of court judgments and erode the taxpayer's confidence in the stability and finality of tax assessments. If implemented, the changes will upset innumerable completed assessments, both of companies and their shareholders. During the current debate in Parliament, a Member described the proposed retroactive legislation as an attempt to collect taxes "more by crook than by hook". The Finance Minister has not relented so far but his proposed action raised the important question, whether, in the absence of an emergency or exceptional situation, retroactive legislation to remove ambiguities resulting from bad drafting and bureaucratic ineptitude can be justified as a matter of sound fiscal policy.

# HIGHLIGHTS OF THE INDIAN CENTRAL BUDGET FOR 1980-81

The following are the main proposals of the 1980 Budget presented by the Union Minister, Mr. R. Venkataraman, on June 18, 1980 before the Lok Sabha:

## A. INCOME TAX

### 1. CORPORATE TAXATION

a) *Rate of tax*

No change is proposed in the existing corporate tax rate structure.

b) *Tax holiday on profits of a new industrial undertaking*

Under the present law five-year tax holiday is available on new industrial undertakings set up before 1st April, 1981, and this relief is calculated at 7.5 percent of the capital employed in the undertaking. It has now been proposed that this tax holiday will be extended upto March 31, 1985, but the calculation of this tax holiday will not be on the capital employed in the undertaking but on the profits of the new industrial undertaking as under:

In case of companies
— 25 percent of the profits derived from the new industrial undertaking during the relevant year.

In other cases
— 20 percent of the profits derived from the new industrial undertaking during the relevant year.

This tax holiday will be available for a period of seven years and will apply to those undertakings which qualify for the tax holiday under the existing law.

It has also been proposed that the profits of the new industrial undertaking for the purpose of this claim will be computed after taking into account losses, depreciation and investment allowance if any of earlier years in respect of the new industrial undertaking.

The basis of computation of the capital employed in the new industrial undertaking for determining the tax holiday available upto March 31, 1981 is proposed to be incorporated in the Income Tax Act itself (instead of the Income Tax Rules) wherein it has been made clear that in computing such capital borrowings will not be included. This amendment will be applicable with retrospective effect from 1972/73 assessment onwards, if approved.

c) *Additional depreciation on plant & machinery in certain cases*

It has been proposed that additional depreciation at 50 percent of the normal depreciation allowance (excluding extra shift allowance) will be available on new plant and machinery installed after March 31, 1980 but before April 1, 1984. This will be available only in the year of installation.

Additional depreciation will be taken into account in calculating the written down value of the plant and machinery.

Additional depreciation will not be available on ships, aircraft, road transport vehicles, office appliances, machinery or plants installed in any office premises or in residential accommodation or in guest houses etc.

Additional depreciation will also not be allowed on any plant and machinery the whole of the actual cost of which is allowed as deduction.

d) *Expenditure on scientific research*

To encourage in-house research and development activities it has been proposed to allow a weighted deduction equal to 1 1/4 times of the expenditure incurred in approved in-house research and development or carrying out any research programme approved by the prescribed authority. The proposed deduction will not be allowed on expenditure incurred in acquiring land or construction of buildings.

e) *Expenditure on advertisement, publicity and sales promotion*

Under the existing law there are certain restrictions on advertisement, publicity and sales promotion expenses; it has been proposed to withdraw the restrictions.

f) *Export market development allowance*

It has been proposed to amend the Income Tax Act to clarify that the weighted deduction for export market development allowance will be available only on the following expenditure:

(i) advertisement or publicity outside India in respect of the goods, services or facilities dealt in or provided by the taxpayer in the course of his business;
(ii) maintenance outside India of a branch, office or agency for the promotion of the sale outside India of such goods, services or facilities;
(iii) travelling outside India for the promotion of the sale outside India of such goods, services or facilities, including travelling outward from and return to India.

### 2. PERSONAL TAXATION

a) *Surcharge*

The rate of surcharge on income-tax has been reduced from 20 percent to 10 percent. This will mean that the top slab rate will now come down from 72 to 66 percent.

b) *Raising of exemption limit*

The exemption limit in the case of individuals is proposed to be raised from Rs. 10,000 to Rs. 12,000. However, there has been no change in the slab rates.

c) *Deduction in respect of Life Insurance Premium, contributions to Provident Fund etc.*

The existing rates at which deduction is allowed is:

| | | |
|---|---|---|
| On | first Rs. 5000 | 100% |
| | next Rs. 5000 | 35% |
| | balance | 20% |

It has been proposed to increase the rates as under:

| | | |
|---|---|---|
| On | first Rs. 5000 | 100% |
| | next Rs. 5000 | 50% |
| | balance | 40% |

d) *Interest credited to member's account in the Provident Fund*

Under the existing law interest credited to a member's account in a recognised Provident Fund in excess of 8.25 percent or in excess of 1/3rd of his salary is liable to be taxed in his hands.

It has been proposed in this budget that the second condition that is interest exceeding 1/3rd of the salary being liable to tax in the hands of the employee should be abolished.

e) *Standard deduction to pensioners*

Under the existing law standard deduction in respect of expenses incidental to employment is allowed against salary income of an employee. The standard deduction is allowed at the rate of 20 percent of the salary upto Rs. 10,000 and 10 percent of the salary in excess thereof, subject to a maximum of Rs. 3,500,–. This deduction is allowed irrespective of whether any expenditure incidental to employment is actually incurred by the employee or not.

It has been proposed that the standard deduction will also be allowed on pensions.

## B. WEALTH TAX

(i) It has been proposed to raise the exemption limit for wealth tax purposes from Rs. 100,000 to Rs. 150,000.
(ii) There is no change in the rates of tax.

## C. INDIRECT TAXATION

### 1. CUSTOMS DUTY

Revision in the rates of import duty has been proposed in some cases. A few examples are given below:

a. on all dutiable articles imported as personal baggage the rate is increased from 120 percent ad valorem to 150 percent;
b. on computers and computer peripheral units rate increased from 10 percent ad valorem to 20 percent;
c. on cinematograph films rate increased from 50 paise to Re 1/- per liner metre;
d. full exemption from import duty has been proposed for steel tubes imported for use in the manufacture of industrial gas cylinders of certain specifications;
e. reduction in the import duty has been proposed on certain machineries and testing instrument for printing industry; also for certain other items of machinery and testing instruments.

### 2. EXCISE DUTY

It is proposed to revise the rates on the following items as under:

a. soda ash raised from 10 to 15 percent ad valorem;
b. caustic soda and caustic potash raised from 10 to 15 percent ad valorem;
c. acids raised from 10 to 15 percent ad valorem;
d. synthetic rubber raised from 5 to 10 percent;
e. on cheaper varieties of toilet soaps reduced from 10 to 5 percent, on toothpaste from 20 to 10 percent;
f. cigarettes which are at present exempt from special excise duty will be levied duty at the rate of 1/10th of the basic duty;
g. excise duty on cheaper television sets reduced from 15 to 10 percent and duty on other television sets reduced from 30 to 25 percent;
h. licence fees abolished on single and two-band radio sets and transistors;
i. cycles and cycle parts as well as sewing machines totally exempted from excise duty;
j. duty on pressure cookers reduced from 15 to 10 percent;
k. it has been proposed that 30 specified life saving drugs will be fully exempted from excise duty;
l. it has been proposed to raise the special excise duty from 1/20th to 1/10th of the basic excise duty on specified items. It has been also proposed to levy special excise duty at the rate of 1/20th of basic duty on some items which are now exempt from such levy.

### 3. POSTAL TARIFF

a) Postal tariff on letters increased from 30 p to 35 p. but no increase is proposed on inland letters and postcards; postal parcel increased from Rs. 1.50 to Rs. 2 per 500 gms; and
b) Higher charges will be made for shifting and installing telephones. Local telephone calls beyond 5000 in a quarter to be charged at 50 p. per call against 40 p. at present.

## D. OTHERS

The Finance Minister has indicated that a Bill will be introduced in the current session of the Parliament to levy a new tax at 15 percent on gross receipts of hotels in which the minimum tariff for a single room is Rs. 75/- per day. This new levy is proposed to be made effective from 1st September, 1980.

It is proposed to levy a tax at 7 percent on interest income of banks and financial institutions which will be allowed to be passed on to the borrowers thereby raising the cost of borrowed funds.

# INDIA:
# Budget Speech 1980

Extracts from the Budget Speech 1980 pronounced on June 18, 1980 by the Finance Minister Mr. R. Venkataraman.

With respect to the taxation proposals the Finance Minister said the following:

I now turn to my proposals in the field of direct taxes. In framing these proposals, I have borne in mind certain broad considerations, namely, that the rates of direct taxes should be such as to promote voluntary compliance, that the farmers, workers and the middle class should be afforded some relief in pursuance of the commitment in our party's manifesto and some stimulus should be provided for raising the level of savings and investment in the national economy. At the same time, a concerned attempt should be made to counter certain widely prevalent devices for tax avoidance through fragmentation of income and wealth.

The middle class is among the worst hit by the rise in prices in recent years. As hon'ble members are aware, even skilled workers in the organised sector are now liable to income-tax, at the present level of exemption. In order to afford a measure of relief to this class of persons I propose to raise the exemption limit for income-tax on personal incomes from Rs. 10,000 to Rs. 12,000. With a view to keeping the sacrifice of revenue within management limits, the nil rate slab of income is being retained at Rs. 8,000. As a result, in cases where the taxable income exceeds Rs. 12,000 the incidence of income-tax, excluding surcharge, will remain at the existing levels, subject to the grant of marginal relief in cases where the taxable income exceeds the exemption limit by a small margin. This proposal will benefit more than six lakhs * of income-tax payers.

### Reduction of surcharge

Hon'ble members will recall that the rates of income-tax on the personal incomes were reduced in 1974 on the basis of a recommendation of the Direct Taxes Enquiry Committee and this process was taken one step further in 1976 when these rates were again lowered. The reduction in rates had largely fulfilled the expectation that it would lead to better tax compliance. Unfortunately, the movement in this direction was reversed under the Janata government and the rates of income-tax were increased in stages. I am of the view that the position in this regard should be set right. I accordingly propose to reduce the surcharge on personal incomes in the case of all categories of non-corporate tax payers from 20 percent to 10 percent. This will not only bring down the maximum marginal rate of tax from 72 percent to 66 percent but will benefit tax payers in all slabs of income.

### Reduction of wealth tax

In view of the somewhat steep rise in prices of assets, I also propose to raise the exemption limit for wealth tax from Rs. 1 lakh to Rs. 1.5 lakhs with effect from the current assessment year. In cases where the taxable wealth exceeds this limit, the tax burden will, however, be retained at existing levels, subject to the usual marginal relief.

Government hopes that these concessions will provide the necessary inducement to the vast majority of our tax payers for current declaration of their incomes and wealth.

I propose to counter some of the more commonly used devices for tax avoidance.

### Hindu undivided family

As hon'ble members are aware, the separate treatment accorded to Hindu undivided family in tax laws has been widely used for avoidance of proper tax liabilities. I accordingly propose to de-recognise partial partitions of Hindu undivided families both for income and wealth taxation. Partial partitions made on or after 1st January, 1979, will not be recognised for tax purposes and taxes will continue to be levied on the basis that the existing Hindu undivided family had continued to remain joint.

At present, Hindu undivided families having one or more members with independent income exceeding the exemption limit are charged to income-tax at rates which are somewhat higher than those applicable in the case of individuals. In order to further restrict the use of Hindu undivided family for the purposes of tax avoidance, I propose to raise the rates of income-tax in the case of such Hindu undivided families. The maximum marginal rate of 66 percent will now apply on the slab of income over Rs. 50,000 and rates on some of the lower slabs will also be raised to somewhat higher levels. With these two changes in regard to tax treatment of Hindu undivided families, hope that the urge for forming multiple Hindu undivided families merely for the fragmentation of income and reduction of tax liability will be weakened.

### Discretionary trusts

Hon'ble members will recall that the government had in 1970 taken several measures to prevent the use of private discretionary trusts as a device for tax avoidance. Experience, however, shows that these measures have not been fully effective and the proliferation of such trusts has not been curbed to the desired extent. I, therefore, propose to tighten the provisions in respect of private trusts.

At present, discretionary trusts are taxed at a flat rate of 65 percent of their income and 1.5 percent of their wealth, or at the rates applicable in the case of an individual, whichever is higher. Under my proposal, such trusts will be charged to income-tax at the maximum marginal rate and the wealth-tax at the flat rate of 3 percent or at the appropriate rate applicable in the case of an individual, whichever is higher. I also propose to make several other provisions in relation to taxation of private trusts with a view to plugging some loopholes which have come to the notice of government. All these provisions will take effect from the current assessment year.

### Charities

Charitable and religious trusts are sometimes used for acquiring or maintaining control over business or industry for private ends. In 1975, we have laid down a pattern for investment of funds of charitable or religious trusts if they were to continue to enjoy the tax exemption. With a view to enabling such trusts to change over to the new pattern of investment in a smooth and gradual manner, the law provided that the new pattern may be adopted before 1st April, 1978. This date was subsequently extended to 1st April, 1981. Such trusts have, therefore, been given ample time to adjust to the new policy. I want to put them on notice that this time limit will not be extended.

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* One lakh = 100,000; one crore = 100 lakhs (10 million).

### Long-term savings

Our tax laws have always sought to encourage long-term savings through life insurance, provident funds and other similar instruments. Unfortunately, the efficacy of the provisions for encouraging savings was impaired last year when the incentives for savings were drastically reduced. Hon'ble members should be glad to know that I propose to restore incentives for such savings to the pre-1979 budget levels.

The taxpayers will thus be entitled to 100 percent deduction in respect of the first five thousand rupees of the qualifying savings, 50 percent in respect of the next five thousand rupees and 40 percent of the balance.

As further measure for promoting savings in the household sector, I propose to give an option to income-tax payers to retain moneys in their compulsory deposit accounts beyond the due dates on payment of interest at the existing rate applicable to such deposits. Further, I propose to liberalise the tax exemption in respect of interest on balances with recognised provident funds. At present, interest on such funds is exempt from income-tax to the extent it does not exceed one-third of the salary income of the employee. I propose to remove this ceiling limit.

### Tax incentives

It is essential to promote new investment in industry. At the same time, the fiscal system should not lead to a bias in favour of capital-intensive techniques. Keeping these twin objectives in view, I propose to continue the tax holiday in respect of new industrial undertakings, ships and hotels but in a modified form.

Under my proposal, tax holiday will be available in respect of new industrial undertakings, ships or approved hotels with reference to a specified percentage of the income derived from these sources. In the case of companies, 25 percent of the profits derived from these sources will be exempted for a period of seven years. In the case of non-corporate taxpayers the percentage of exempted profits will be 20 percent.

In the case of co-operative societies, the tax holiday will be available for a period of ten years as against seven years in the case of other categories of taxpayers. This concession will be available in the case of all small-scale industrial undertakings which go into production after 31st March, 1981, but before 1st April, 1985, that is, till the end of the new five-year plan period. For other industrial undertakings, the concession will apply only where they do not produce articles or things listed in the Eleventh Schedule to the Income-Tax Act. The concession will also be available in the case of approved hotels which start functioning or new ships which are acquired during that period.

It is necessary to encourage new investment particularly in view of shortages in several key sectors of the economy. As a special stimulus for new investment, I propose to allow in the year of installation, an additional depreciation in an amount equal to 50 percent of the normal depreciation on new machinery or plant installed during the new plan period. The proposed additional depreciation will not be admissible in respect of ships, aircraft, road transport vehicles, office appliances or machinery or plant installed in office premises or residential accommodation.

There is a widespread feeling of frustration among the scientific community. This government is keenly aware of the contribution which our scientists and technologists can make to the economic regeneration of India and is determined to promote research and development activities in a big way.

I, therefore, propose to allow a weighted deduction in an amount equal to 125 percent of the actual expenditure incurred on scientific research in any in-house R and D facility where such expenditure is incurred on a programme approved by the prescribed authority having regard to the social, economic and industrial needs of India. In addition, I propose to extend, the scope of the existing provision for a weighted deduction on the expenditure incurred in scientific research under sponsored programmes in approved laboratories so as to cover the expenditure similarly incurred in in-house R and D facilities of public sector companies. I have no doubt that the hon'ble members will welcome these concessions.

### Advance tax

At present, income-tax payers are required to pay advance tax during the financial year on the basis of their own statements or estimates.

Where the estimated advance tax is likely to fall short of the tax on current income by more than 33-1/3 percent of the estimate, the taxpayers are required to make an upward revision of the estimates. I propose to reduce this margin from 33-1/3 percent to 20 percent in the case of companies. There will be no change for other taxpayers. This change will enable us to realise a larger share of the tax due as advance tax and thus have a favourable impact on government's ways and means position in 1980-81.

### Employment of handicapped

In order to encourage the employment of blind and handicapped persons in business and industry, I propose to provide for a weighted deduction of one and one-third times the salary paid to such persons by employers where such salary does not exceed twenty thousand rupees in a year. Further, I propose to enhance the deduction currently available in computing the taxable income of blind and handicapped persons from five thousand rupees to ten thousand rupees.

### Pensioners

At present, standard deduction in computing the salary income is not available in the case of pensioners. With a view to affording some relief to pensioners who are amongst the worst hit by the rise in prices, I propose to extend the benefit of standard deduction in their case as well.

### Sportsmen

In order to encourage our sportsmen to compete in international events, I propose to allow a deduction, equal to 25 percent of their foreign earnings if these are brought into India in foreign exchange. This provision will apply in relation to the current assessment year and onwards. I also propose to allow higher deduction in respect of savings made by sportsmen through life-insurance and provident funds etc., as currently available in the case of authors, playwrights, artists, musicians and actors. Sportsmen will thus be entitled to deduct contributions made to life insurance and provident funds up to 40 percent of their professional income and 30 percent of the remaining income, subject to a maximum of Rs. 50,000.

### Publicity

In 1978, certain restrictions were placed on the deductible amount of expenditure on advertisement, publicity and sales promotion. These restrictions have particularly hurt small and medium business. I, therefore, propose to do away with these restrictions.

### Agriculture

At present, income from poultry and dairy farming and livestock breeding is exempt from income-tax up to 33-1/3 percent of such income or ten thousand rupees, whichever is higher. I feel that time has come when persons deriving income from these sources should also contribute a little more to the national exchequer. I accordingly propose to restrict the deduction in respect of such income to one-third of such income or fifteen thousand rupees, whichever is less.

At present, agricultural property is included in the taxable wealth for the purposes of the levy of wealth-tax. At the time when agricultural property was brought within the tax net, it was hoped that it would be a potent instrument for mobilising resources from the affluent section of agriculturists. But our experience of over the last decade has been most disappointing. The amount realised as wealth-tax on agricultural property has generally been less than Rs. 1 crore per annum. The valuation of agricultural land has posed difficulties leading to complaints of harassment. As this tax has clearly failed to achieve its original objective, I propose to discontinue the levy of wealth-tax on agricultural property except in the case of owners of tea, coffee, rubber and cardamom plantations. I am sure that this measure will be widely welcomed by our farmers.

### Other measures

I also propose to make certain amendments in the Income-Tax Act to counteract certain court decisions which have resulted in unintended benefit to taxpayers. The Finance Bill further contains certain proposals for the amendment of direct taxes which are of minor significance. I will not take the valuable time of the House in explaining the same.

The reduction in rates and other concessions in respect of direct taxes should ordinarily involve loss of revenue. However, I am of the view that reduction in rates will lead to significantly improved compliance with tax laws. The legislative amendments made for countering tax avoidance devices and the changes in the provisions in regard to advance tax should result in larger accretion of revenue. On a broad judgement of the overall impact of all the proposals relating to income-tax and wealth-tax, I am not assuming any loss of revenue. I recognise, however, that there may be need for some adjustment in the inter-se shares of Centre and states under income tax. Such adjustments will be made in the course of the year in the light of trends in collections.

An upward adjustment of leading rates should moderate the inflationary pressures in the economy. I accordingly propose to revive interest-tax in relation to interest earned by scheduled commercial banks after 30th June, 1980. The scope of the levy is being extended to cover also interest received by the larger all-India industrial finance institutions, namely, IDBI, ICICI, IFCI and IRCI. The tax will be levied at the rate of 7 percent on the chargeable amount of interest as in the past. This measure will yield Rs. 217 crores in a full year and about Rs. 108.5 crores in the year 1980-81.

With a view to checking lavish expenditure incurred on accommodation and entertainment in luxury hotels, I propose to introduce a bill in the current session to levy a new tax at 15 percent on gross receipts of hotels in which the minimum tariff for a single room is 75 rupees per day. The new levy is proposed to be made effective from 1st September 1980. This will yield about Rs. 12 crores in a full year and the revenue during 1980-81 will be of the order of Rs. 5 crores.

### Indirect taxes

I shall now turn to my proposals on indirect taxes. In framing my proposal I have kept in view the following objectives: to the extent additional resource mobilisation is inescapable, this should be done in such a way as not to enhance the burden on any commodity significantly. Subject to this consideration, the small segment of our industry should be encouraged. Industries with significant employment and export potential should be provided encouragement through suitable adjustment of duty structure. The duty burden on some articles of common consumption should be reduced or totally removed.

At the outset I would like to put the hon'ble members at ease by pointing out that my proposals are modest. I have tried to avoid the usual device of picking out selected items for new or increased levies at relatively high rates.

For this year, I have sought to spread the effect of the additional taxation thinly on a wide range of products, taking care to leave out articles of common consumption. I propose to achieve this objective through the special excise duty which is even now leviable on all excisable goods at 1/20th of the basic excise duty, but from which a number of commodities have been exempted.

Under my proposal, the special excise duty will be levied on those items which are at present exempt from the levy, at the rate of 1/20th of the effective basic excise duty rates applicable. Certain commodities will, however, continue to be totally exempt from the levy. Thus there will be no special duty on motor spirit including naphtha, kerosene, high speed diesel oil, light diesel oil and liquefied petroleum gas or on coal or electricity.

Again, the special excise duty will not be levied on matches, or on vanaspati, or on goods falling under tariff item 68. Where special excise is already leviable at 1/20th of the effective basic duty, I propose to increase this to 1/10th of the effective basic duty.

This increase will not, however, apply to furnace oil, asphalt, bitumen and tar, petroleum products not otherwise specified and calcined petroleum coke. Sugar and processed vegetable non-essential oils will also not be subjected to the increased levy.

Cigarettes, which are at present totally exempt from special excise duty, will be subjected to special excise duty at 1/10th of the basic excise duty rates. These proposals would yield a revenue of Rs. 197.71 crores in a full year. The impact of these proposals relating to special excise duties will also yield sum of Rs. 16.75 crores in the shape of countervailing duties on imported goods.

Soda ash and caustic soda command a sizable premium in the market on account of persistent shortages. I propose to mop up a part of this premium by raising the excise duty on these products from ten percent to fifteen percent ad valorem. I also propose to increase the excise duty on starch from ten percent to fifteen percent ad valorem.

This step will bring these chemical products on a par with other chemical products, which, in general, bear excise duty at 15 percent ad valorem. Synthetic rubber at present bears duty at the very low level of five percent ad valorem.

As a revenue measure, I propose to raise the excise duty on synthetic rubber from five percent to ten percent ad valorem. Similarly, the rate of excise duty on specified acids is being raised from ten percent to fifteen percent ad valorem. These measures would fetch in a full year, additional revenue of Rs. 18.93 crores.

On revenue considerations, I propose to subject molasses to a specific duty of Rs. 30 per metric tonne under a separate item in the central excise tariff instead of eight percent under item 68 of the central excise tariff as at present. The levy is, however, proposed to be restricted to molasses produced in vacuum pan sugar factories. Molasses produced in khandsari sugar units, which go inter alia for edible purposes, are proposed to be exempted. The revenue yield as a result of this proposal is estimated to be Rs. 4.24 crores in a year.

### Protection of industry

I now come to proposals which are designed to provide a higher degree of protection to certain sectors of indigenous industry. The first proposal related to audio frequency amplifiers, an item reserved for the small-scale sector.

In view of the adverse effect of imports of this item, I propose to increase the customs duty on imports from 75 percent to 120 percent ad valorem.

My other proposal relates to imported unexposed colour positive cinematograph films, in respect of which the basic customs duty is proposed to be raised from 50 paise to Rs. 1 per linear metre to enable the indigenous public sector unit to withstand competition from imports. I also propose to increase the countervailing duty on imported computers from ten percent to 20 percent ad valorem as a measure of affording protection to the indigenous computer industry.

These measures are designed to yield additional revenue of about Rs. 1.83 crores in a full year.

I have only one more revenue proposal in the field of indirect taxes. This relates to passengers' baggage. As hon'ble members are aware, baggage allowances were substantially liberalised in 1978 and, for the generality of Indian passengers going abroad for short visits, the allowances consist of Rs. 1,000 worth of duty-free goods and Rs. 2,000 worth of goods on payment of duty. Despite this liberalisation, goods in the nature of baggage continue to be imported by many passengers in quantitites substantially higher than the permissible limits.

This is mainly due to the prevailing craze for foreign goods and the high margin of profits on the sale of these goods in India. Such cases of import of baggage items in excess of the permissible limits necessitate initiation of adjudication proceedings which generally have the effect of slowing down the tempo of passenger clearance in out international airports.

I have given thought to this problem and I am making two proposals in this regard. The first is a pure revenue measure of increasing the effective rate of duty on baggage articles in excess of the free allowances from 120 percent ad valorem to 150 percent ad valorem. This measure is to come into force immediately and is expected to yield an additional Rs. 20 crores in a full year.

The second measure to be brought into force shortly, provides for the levy of duty at a flat rate of 320 percent on baggage imported in excess of the permissible limits, that is, in excess of what can be passed free or on a duty of 150 percent.

At present, such articles would be treated as unlicensed imports, resulting in confiscations, fines and penalties, designed to wipe out any profit on their sale.

The increased rate of duty is intended to replace these fines and penalties, without having to go through the time-consuming process of adjudication. Goods which are obviously in the nature of trade goods will, however, still attract penal action.

#### Rationalisation measures

I have a few other proposals which are essentially in the nature of rationalisation measures.

The first one relates to aerated waters. In the interest of simplification, it is proposed to do away with the existing distinction between aerated waters containing caffeine and those not containing caffeine for the purpose of excise duty.

Instead, it is proposed to levy on all flavoured aerated waters a uniform duty at 40 percent ad valorem. The revenue effect of the proposal is expected to be negligible.

I have given considerable thought to the problems thrown up as a result of the changes made in the 1979 budget in the excise duty structure applicable to the match industry.

While the duty advantage enjoyed by the cottage sector obviously needs to be maintained, the non-mechanised middle sector should not be allowed to make inroads into the cottage sector.

In order to ensure that the benefit of the lower rate of duty accrues only to the genuine cottage sector units, I propose to confine the duty concession to match boxed bearing approved labels and sold to or marketed through the KVIC, state agencies and registered cooperative societies.

At the same time, I do not find justification for the continuance of the existing limits placed on the clearances of matches by the cottage sector at the concessional rate of duty. I, therefore, propose to abolish the existing limit on production by the cottage sector units. I am confident that this package of measures will result in accelerated growth of the cottage sector of the match industry.

There have been complaints of malpractices in the biri industry by manufacturers who have been taking advantage of the liberal exemption limit applicable to the unbranded sector which is at present 60 lakhs of biris per manufacturer per year.

With a view to reducing the possibilities of malpractices, I propose to lower this exemption limit to 30 lakhs of unbranded biris per manufacturer per year, which will still leave out of the excise net the really small manufacturer and the self-employed manufacturer. This is not designed as a revenue measure.

Some of the provisions in the Finance Bill are aimed at rationalisation or clearer definition of certain central excise tariff items to remove doubts or difficulties which have come to notice. The details of these measures may be found in the budget papers.

#### Concessions

I shall now turn to concessions in the area of indirect taxes. The small manufacturer plays a significant role in our economy. I would like to improve his competitive position vis-a-vis the large manufacturer and thus widen the entrepreneurial base of our economy.

Only in this way can we check concentration of economic power. There is already a scheme of excise duty concessions applicable to manufacturers of 70 excisable commodities, under which clearances upto Rs. 5 lakhs in value in a year have been exempted from duty.

I now propose to liberalise this concession in two respects. First I propose to include two more groups of commodities under the scheme. These are chemicals, namely, sodium, bi-chromate, bleaching powder, calcium carbide and artificial and synthetic resins and plastic materials. Besides, the coverage is being widened in respect of paper and paper boards. But the second and more important concession which I propose to introduce is that in respect of all the commodities covered by the scheme, clearances between Rs. 5 lakhs and Rs. 15 lakhs will bear only three-fourths of the applicable rate of excise duty as against the normal duty at present. This measure should benefit a large number of small manufacturers. The revenue sacrifice will be of the order of Rs. 6.50 crores in a full year.

Last year's budget made a change which affected a substantial number of small manufacturers of goods falling under the residuary item 68 of the Central Excise Tariff. Hon'ble members will recall that the quantum of duty-free clearances was reduced from Rs. 30 lakhs to Rs. 15 lakhs. I had opposed this change then.

As a measure of undoing the hardship caused to such small manufacturers, I propose to provide for complete exemption from duty for clearances up to Rs. 30 lakhs per annum. In other words, small manufacturers of goods falling under item 68 of the Central Excise Tariff, whose capital investment on plant and machinery does not exceed Rs. 10 lakhs, will be eligible for complete exemption from duty on their first clearances of goods up to Rs. 30 lakhs in a financial year. The quantum of clearances eligible for full exemption from duty will be fixed at a correspondingly lower figure. This concession is expected to cost Rs. 2.4 crores in a full year.

Paper and allied products are in short supply in the country and new investment in this sector has not been readily forthcoming. Much can be done by smaller units to help in filling the production gap. To encourage them, I propose to extend a concessional rate of duty of 20 percent ad valorem as against the present rate of 30 percent to paper and paper board produced by small manufacturers whose clearances in the preceding financial year did not exceed 300 tonnes of paper and paper board. This concession will cost a little less than Rs. 1 crore in a full year.

The electronics industry has considerable employment and export potential. We have the necessary skills and expertise and these should be harnessed through appropriate fiscal incentives for development of the electronics industry in a big way.

This is a field which offers great scope to small-scale manufacturers. I am, therefore, proposing some duty concessions in respect of the industry.

There will be a reduction in customs duty on specified items of capital goods such as machines and instruments required by the electricals industry and not produced within the country. The customs duty on such items will be reduced from the present levels of duty (which in some cases are as high as 89 percent ad valorem) to a total of 25 percent ad valorem.

Similarly, I also propose to reduce the customs duty on specified raw materials and components required for the electronics industry from their present levels (which in some cases are higher than 200 percent ad valorem) to 45 percent ad valorem plus countervailing duty where an excise duty is leviable under item 68. These two concessions will cost the exchequer Rs. 4.7 crores in a full year.

The experience of other countries shows that the growth of consumer electronics facilitates in due course the development of other sophisticated lines of production in electronics.

Television is a powerful medium of communication and education. With a view to enabling a larger number of people to get the benefit of this medium, I propose to reduce the excise duty on cheaper priced TV sets from 15 percent to 10 percent ad valorem, and to effect a corresponding reduction in the duty on other TV sets from 30 percent to 25 percent ad valorem. These concessions would entail a revenue sacrifice of Rs. 1.5 crores in a year.

Radio is an equally powerful instrument of education and entertainment and is more widely in use. Government considers that single and two band radio sets should be popularised particularly in rural areas. The licence fee on such sets has proved to be irksome and inhibits purchase of radio sets by the rural folk. It is, therefore, proposed to abolish the fee in respect of single and two band radio sets including transistor sets. This measure, which I am sure will be widely welcomed, will cost government about Rs. 4 crores.

Our computer industry is still in its infancy, compared with those of other countries. In order to provide an additional incentive for indigenous production and improvement, I propose to reduce the excise duty on indigenously manufactured computers from 25 percent to 20 percent ad valorem.

### Ship building

Ship building is a high priority industry and has an important part to play in promoting economic self-reliance. The Indian ship building industry is finding it increasingly difficult to face competition from foreign shipyards. I, therefore, propose to extend full exemption from excise duty to ocean going vessels built in Indian shipyards. This relief would cost about Rs. 5 crores in the current financial year.

Hon'ble members would be aware that government has been following the practice of bringing down the import duty on selected machinery items having no indigenous angle to 25 percent ad valorem as a measure of reducing capital costs in industries.

### Other industries

Carrying this process further, I propose, this year, to reduce the import duty to 25 percent ad valorem on twelve more items of capital equipment. These include five items of machinery used in the printing industry, such as high speed letter press rotary and off-set rotary printing machines, mono lino type casting machines etc. These concessions would entail a revenue sacrifice of Rs. 1.84 crores in a full year.

The cost of high pressure gas cylinders constitutes a significant portion of the total capital outlay required by the glass industry. With a view to reducing, at least in part, this capital outlay, I propose to extend complete exemption from customs duty on steel tubes imported for fabrication of high pressure gas cylinders. I also propose to reduce the excise duty on such cylinders from the existing level of 15 percent to 8 percent ad valorem, which is the duty level applicable under item 68. These two measures, taken together, are estimated to cost Rs. 1.89 crores in a full year.

I have a proposal of general application, which is intended to facilitate manufacturers of excisable goods, using inputs on which excise duty is leviable. In order to give relief in such cases, two procedures are in vogue at present. One is what is called the set-off procedure. The other is the proforma credit procedure under Rule 56A of the Central Excise Rules.

The proforma credit procedure is generally recognised to be more beneficial and less irksome to the manufacturers. I, therefore, propose to replace the existing concessions based on the set-off procedure by similar concessions based on the proforma credit procedure. I am sure that this measure will be welcomed by industry.

### Consumption goods

It is a little painful for me to remind hon'ble members that last year's budget had increased excise duty on a number of articles of common consumption to a significant extent. I propose to reverse this trend. Thus —

— specified life-saving drugs, 30 in number, will be fully exempted from excise duty. The list will be kept under periodical review with a view to adding more items as may be warranted.

— controlled cloth is meant for the weaker sections of society and its cost should be as low as possible. I, therefore, propose to exempt controlled cloth from excise duty.

— cotton and cotton-viscose blend hosiery consisting of items like banians are of relatively low value and these are now subject to excise duty at 8 percent. I propose to exempt them fully from excise duty.

— cycles are the poor man's conveyance. I, therefore, propose to totally exempt cycles and cycle parts falling under item 68 from excise duty.

— sewing machines, which are indispensable to the housewife and also enable the weaker sections to earn a living, will also be fully exempt from excise duty.

— pressure cookers which take the drudgery out of the housewife's daily tasks and save fuel now attract duty at 15 percent. I propose to reduce it to 10 percent.

I also propose to make substantial reductions in excise duty on some other items of everyday use, accordingly—

— excise duty on cheaper varieties of toilet soap will be reduced from 10 percent to 5 percent.

— excise duty on tooth paste will be reduced from 20 percent to 10 percent.

— vacuum and gas-filled bulbs not exceeding 60 watts will have the duty reduced from 15 percent to 10 percent.

I am sure these substantial concessions, which would cost the exchequer approximately Rs. 15 crores in a full year, will be welcomed by Parliament and by the public. I also hope that industry and trade will play fair by the consumer and pass on the benefit of these duty reductions to the consumer.

### Transportation

Our party's election manifesto has referred to the need to encourage dieselisation of taxis. In fulfillment of this commitment and with a view of giving an incentive for taxi-owners to go in for dieselisation, I propose to extend full excise duty exemption to diesel engines used for conversion of petrol-driven taxis.

My second proposal is aimed at giving relief to the cycle rickshaw drivers. Powered cycle rickshaws are already exempt from excise duty. To encourage motorisation of non-powered cycle rickshaws, I propose to extend full duty exemption for internal combustion engines used for this purpose. I am sure hon'ble members will welcome this measure, as a visible sign of our keenness to reduce physical strain and at the same time encourage this relatively cheap means of transport.

#### New tribunal

Before I leave the field of indirect taxes, I have a major decision of policy to announce. For the past couple of decades, there has been a persistent public demand for the setting up of an independent appellate tribunal for customs and Central Excise matters, somewhat similar to the set-up on the direct taxes side.

This demand has recently been endorsed by the Estimates Committee of Parliament. Government has, in the past, not been in favour of such a system, as it was felt that it would not be appropriate in the case of indirect taxes, and that the present departmental machinery was in fact adopting an objective approach.

I think a time has come when we should gracefully accept the common view, which is based on the dictum that justice should not only be done but should also seem to be done. It is in this spirit that provision has been made in the Finance Bill for setting up an appellate tribunal to hear appeals in respect of customs, Central Excise and gold control matters.

This tribunal will be independent of the executive machinery charged with the responsibility of day-to-day administration of revenue laws. I have no doubt that this measure will meet with the whole-hearted approval of Parliament and of trade and industry.

My taxation proposals will yield a sum of Rs. 223.22 crores in a full year in Central Excise duties and Rs. 39.58 crores in customs duties. The reliefs I have announced add up to Rs. 34.75 crores on the Central Excise side and Rs. 7.93 crores on the customs side.

The net yield is, therefore, Rs. 188.47 crores from Central excise duties and Rs. 31.65 crores from customs duties. The accrual to the Central exchequer in a full year will be Rs. 144.85 crores and the share of the states will be Rs. 75.27 crores.

Where changes are proposed to be made by notifications, effective from the 19th June, 1980, copies of such notifications will be laid on the table of the House in due course.

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IFA

international fiscal association

# TVA ET PRESTATIONS DE SERVICES

Journée d'études franco-belgo-luxembourgeoise du 7 mars 1980

*For an English translation of this Introduction and English summaries of the other French texts, see at the end of this Article.*

## INTRODUCTION

Par Prof. Dr. Paul Sibille

*Plusieurs groupements nationaux de l'Association Internationale de Droit Fiscal (I.F.A.) entretiennent depuis plusieurs années l'excellente coutume de rencontres bilatérales au cours desquelles des rapports sont présentés et des discussions engagées sur des thèmes et des questions qui intéressent particulièrement leurs pays.*

*C'est ainsi que, pour faire pendant à la journée d'études tenue à Paris en mai 1978, le groupement français et le groupement belgo-luxembourgeois ont organisé une journée d'études à Bruxelles le 7 mars 1980.*

*Cette journée a été consacrée à l'étude des difficultés d'application de l'article 9 de la 6ème directive du Conseil des Communautés européennes du 17 mai 1977 relatif au lieu où une prestation de services est considéré comme exécutée et donne ouverture à la T.V.A. et des solutions qu'il y a lieu d'y apporter (compte tenu de la directive no. 8 relative aux modalités de remboursement de la taxe sur la valeur ajoutée aux assujettis non établis à l'intérieur du pays, qui vient d'être adoptée par le Conseil des Ministres de la Communauté européenne).*

*L'expérience acquise depuis le 1er janvier 1978, date à laquelle la directive no. 6 du Conseil des Communautés européennes est entrée en vigueur, au moins dans certains pays de la Communauté, fait en effet apparaître que l'article 9 de la directive pose des problèmes dont la solution est, dans l'état actuel de la législation des divers pays concernés et des instructions administratives correspondantes, lorsqu'il en existe, loin d'être evidente, quand elle ne varie pas de pays à pays.*

*Les problèmes qui ont été spécialement étudiés au cours de cette journée d'études furent les suivants:*

*a) définir de façon concrète les services énumérés à l'article 9 de la directive, qui sont soustraits par celle-ci au régime de la taxation dans le pays du domicile de l'auteur de la prestation;*

*b) comment le prestataire de services, débiteur d'une T.V.A. dans un pays où il n'est pas établi et n'a pas d'établissement, peut-il faire pour s'acquitter de ses obligations* sans difficultés excessives *sur le plan administratif ou financier?*

*c) comment l'utilisateur d'une prestation de services qui a supporté la charge afférente à ces services peut-il la récupérer* sans difficultés excessives *lorsque, remplissant les conditions voulues pour obtenir cette récupération, il n'est pas établi dans le pays où la T.V.A. a été payée par le prestataire de services?*

*Les séances de travail ont été présidées par M. Henri LEVY MORELLE, Président de la section belgo-luxembourgeoise de l'I.F.A., chargé de cours à L'U.L.B. La co-présidence était assurée par M. Georges EGRET, Secrétaire général du groupement français de l'I.F.A., en l'absence de son Président M. Max LAXAN.*

*L'organisation de cette journée d'études a pu être menée à bonne fin grâce, pour la partie scientifique, à MM. Jean de LONGUEVILLE et Guy van FRAYENHOVEN, respectivement Président et Membre du Comité scientifique du groupement belgo-luxembourgeois, et, pour la partie matérielle, à M. Jacques AUTENNE, Maître de conférences à l'U.C.L., Secrétaire du groupement belgo-luxembourgeois.*

*Le groupement belgo-luxembourgeois se félicite d'avoir trouvé auprès du Bureau International de Documentation Fiscale, à Amsterdam, l'occasion de publier les travaux de cette journée d'études, comportant les rapports, les parties essentielles des exposés et les résumés des débats.*

*Le rassemblement de ces matériaux a pu être réalisé grâce aux notes recueillies et retranscrites par Madame Marie-Cécile van GRIEKEN, assistante à l'Ecole Supérieure des Sciences Fiscales, sous la Direction du Professeur P. SIBILLE, Directeur de l'Ecole.*

*La présente publication constituera sans nul doute un guide précieux pour les juristes et experts fiscaux et pour les entreprises qui sont confrontées continuellement avec l'un des problèmes les plus complexes en matière de T.V.A. dans les relations internationales.*

### INCORPORATION DE LA SIXIEME DIRECTIVE SUR LA T.V.A. DANS LES LEGISLATIONS NATIONALES

Les pays membres des Communautés Européennes ont adapté leur législation relative à la T.V.A. en vertu de la 6ème directive. Les modifications ont pris effet aux dates suivantes:

| | |
|---|---|
| *Belgique* | — le 1er janvier 1978 |
| *Danemark* | — le 1er octobre 1978 |
| *France* | — le 1er janvier 1979 |
| *Irlande* | — le 1er mars 1979 |
| *Italie* | — le 1er avril 1979 |
| *Luxembourg* | — le 1er janvier 1980 |
| *Pays-Bas* | — le 1er janvier 1979 |
| *République Fédérale Allemande* | — le 1er janvier 1980 |
| *Royaume-Uni* | — le 1er janvier 1978 |

# SUJET I: Lieu des prestations de services

## Exposé

## BELGIQUE: Localisation des opérations imposables*

par Jacques Malherbe **

### LIVRAISONS DE BIENS

Aux termes de la directive (art. 8.1.b)) comme du Code belge, la livraison d'un bien a lieu à l'endroit où se trouve ce bien au moment de la livraison.

La directive prévoit que, si un bien est transporté ou expédié, la livraison a lieu au point de départ du transport. S'il fait l'objet d'une installation ou d'un montage, la livraison a lieu à l'endroit où ces travaux se font (art. 8.1.a)).

Le Code belge édicte les mêmes règles en situant au départ du transport ou à la fin de l'installation le moment de la livraison (art. 15, §1, al.2, 1°). Le lieu de celle-ci étant déterminé par la localisation du bien au moment de la livraison, le résultat est identique.

### PRESTATIONS DE SERVICES

La 6ème directive situe le lieu d'une prestation de services au siège de l'activité économique du prestataire ou de l'établissement stable rendant la prestation et, subsidiairement, du domicile ou de la résidence du prestataire (art. 9.1). Il abandonne le critère du lieu d'utilisation du service, introduit par la 2ème directive (art. 6.3) et repris par la réglementation belge (Code, art. 21 ancien et arrêté royal no. 5 du 6 février 1970, relatif au lieu d'utilisation des prestations de services en matière de T.V.A.). L'article 21 nouveau du Code s'aligne sur la directive (§1).

Il adopte également les nombreuses exceptions au critère principal établi par la directive:

a) Les services se rattachant à un immeuble sont localisés au lieu de situation du bien (directive, art. 9.2.a) et Code, art. 21, §3, 1°). Ils comprennent non seulement les travaux immobiliers, mais:
   - les prestations des agents immobiliers comme intermédiaires et des experts;
   - les travaux d'étude ou de contrôle des architectes, géomètres et ingénieurs;

   comme prévu la directive, et en outre:
   - la mise à disposition d'emplacements de parcage de véhicules, d'entreposage de biens, de logements meublés, d'emplacements de camping;
   - la location d'immeubles ou de coffres-forts;
   - la gestion d'immeubles (Code, art. 21, 1° et arrêté royal no. 5 du 27 décembre 1977 concernant les services relatifs à un immeuble par nature en matière de T.V.A.).

b) Les prestations de transport sont rattachées au lieu de transport en fonction des distances parcourues (directive, art. 9.2.b) et Code, art. 21, §3, 3°).

c) L'endroit où les prestations sont matériellement exécutées sert à localiser:
   - les activités culturelles et assimilées, y compris celles de leurs organisateurs et les services accessoires;
   - les activités accessoires au transport, telles que chargement et manutention;
   - les travaux portant sur des biens meubles corporels, y compris les expertises (directive, art. 9.2.c)). En ce qui concerne ces derniers, le Code belge les localise à l'endroit où se situe le bien (art. 21, §3, 2°). Cet endroit coïncide normalement avec le lieu d'exécution du travail.

d) La location de biens meubles corporels, autres que des moyens de transport, est localisée à l'endroit de leur utilisation. Si le loueur est établi dans la CEE, encore faut-il que le bien soit exporté dans l'Etat d'utilisation (directive, art. 9.2.d); Code, art. 21, §3, 5°).

e) Le siège de l'activité économique du preneur ou de l'établissement stable pour lequel la prestation de services est rendue et, subsidiairement, le domicile ou la résidence du preneur, est considéré comme lieu de prestation des services suivants:
   - cession ou concession de droits intellectuels, auxquels le Code ajoute les monopoles de vente ou d'achat et le droit d'exercer une activité professionnelle;
   - publicité;
   - travaux intellectuels des conseillers, ingénieurs, bureaux d'études, experts comptables, à l'exclusion, en Belgique, pendant la période transitoire, des avocats;
   - l'engagement de ne pas exercer une activité professionnelle ou un droit intellectuel;
   - les opérations bancaires et financières, autres que la location de coffres-forts, les opérations d'assurance étant exonérées;
   - la mise à disposition de personnel;
   - les services des intermédiaires autres, précise le Code, que les commissionnaires qui sont réputés acheteurs ou vendeurs, intervenant dans la fourniture des prestations énumérées ici (directive, art. 9.2.e); Code, art. 21, §3, 7°).

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* Extrait de la Communication faite à l'Université des Sciences sociales de TOULOUSE, les 29/30 novembre 1979.

** Maître de conférences à l'Université de Louvain, Avocat au barreau de Bruxelles.

## FRANCE: Documentation

### Lieu d'imposition des prestations de services et définition du contenu des prestations de services

*La loi française:* Code général des impôts (CGI), articles 259, 259A, 259B et 259C

I. *Rappel du cas général:*

Lieu de prestataire, Instruction administrative du 15 février 1979

II. *Les exceptions au cas général:*

A. Locations de biens meubles corporels (CGI, Article 259 A-1°, Compte rendu du Comité Fiscal du 29 mars 1979, Instr. Adm. 3 A-19-79 du 10 décembre 1979, Article 24 Annexe I du CGI)

B. Prestations se rattachant à un immeuble (CGI, Article 259 A-2°, Instr. Adm. du 15 février 1979)

C. Prestations de transport et prestations accessoires au transport (CGI, Article 259 A-3°, Instr. Adm. du 15 février 1979, Document de base 3A 233, Annexe III du CGI)

D. Prestations imposables au lieu de leur exécution (CGI, Article 259 A-4°, Instr. Adm. du 15 février 1979)

E. Prestations de caractère immatériel (CGI, Articles 259 B et C, Instr. Adm. du 15 février 1979, Compte rendu du Comité fiscal du 29 mars 1979, Instr. Adm. 3A-17-79 du 13 novembre 1979, Article 24, Annexe I du CGI)

## LUXEMBOURG: Le régime de la taxe sur la valeur ajoutée appliqué aux prestations de services suite aux modifications législatives intervenues en raison de la 6ème directive

par Rodolphe Gerbes * et Yves Prussen **

**Sommaire**



### I. INTRODUCTION

La sixième directive du Conseil des Communautés Européennes en matière de TVA s'est traduite au Grand Duché de Luxembourg par une loi du 12 février 1979, qui est entrée en vigueur le 1er janvier 1980.

En théorie cette modification législative a apporté des changements importants dans la taxation des prestations de services effectués par des assujettis à la TVA, les prestations de services étant définis par la loi comme opération ne constituant ni une livraison de biens ni une importation, et l'assujetti étant défini comme toute personne, résidente ou non, effectuant de façon indépendante et à titre habituel des opérations relevant d'une activité économique quelconque. Conformément à l'article 2 de la loi organique de la TVA, sont soumises à la taxe les prestations effectuées à titre onéreux à l'intérieur du pays.

En l'occurrence ces changements sont le résultat d'une optique fondamentalement différente que la sixième directive a imposée dans la définition du lieu d'une prestation de service. D'autres changements paraissent plutôt de nature pratique, les principes afférents étant comparables à ceux ayant déjà existé sous l'ancienne législation. Tel est notamment le cas pour certains des services énumérés à l'article 9 de la directive.

Le système antérieurement en vigueur a paru simple, mais son application donnait lieu à des difficultés notamment en raison des interprétations divergentes dans les différents pays-membres de la CEE.

En effet, conformément à l'article 17 (ancien) de la loi organique de la TVA, le lieu de la prestation de service était réputé se situer à l'endroit où le service rendu était utilisé ou exploité. Ce principe prévoyait en conséquence l'assujettissement à la taxe des prestations de service facturées par des étrangers à des résidents du Grand Duché, à moins qu'il ne pouvait être prouvé que ces services étaient effictivement utilisés ou exploités en dehors du territoire grand-ducal.

En ce qui concerne les assujettis établis dans le Grand-Duché de Luxembourg, il existait une exonération correspondante en ce que les prestations de service effectuées pour le compte des commettants étrangers pour les besoins de leur entreprise, se trouvaient exonérées.

La difficulté principale consistait à déterminer le lieu de l'utilisation, et la tendance de certaines administrations fiscales de localiser l'utilisation du service dans leur pays a entraîné des désavantages certains pour beaucoup de preneurs assujettis.

C'est pour atteindre une harmonisation plus poussée des législations et de leur interprétation que le critère du lieu d'utilisation du service a été abandonné.

En conformité avec la sixième directive, la loi du 12

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** Avocat, Elvinger & Hoss.

février 1979 a posé comme principe que, sauf exception, toutes les prestations exécutées ou réputées exécutées à l'interieur du territoire sont soumises à la TVA, étant entendu qu'en principe le lieu de la prestation du service est le lieu de l'établissement stable à partir duquel le service est rendu. La sixième directive est ainsi plus proche du principe retenu par la loi allemande aux termes duquel un service est presté à l'intérieur du pays si l'entrepreneur y déploit son activité de facon prépondérante (par. 3 al. 10 UStG.), mais elle a introduit la présomption irréfragable que, sauf exception, ce qu'elle prévoit, l'activité est exercée au siège économique ou dans l'établissement stable du prestataire. Au Grand-Duché, l'établissement stable n'est pas défini dans la loi organique de la TVA. Il faut donc se référer à la législation sur les impôts directs (loi d'adaptation fiscale paragraphe 16).

Les exceptions sont énumérées à l'article 9 de la directive qui prévoient un régime s'inspirant du principe de l'article 6 al. 3 de la seconde directive (lieu d'utilisation effectif du service) qui avait été repris par l'ancien article 17 de la loi, même si cela ne ressort pas des travaux préparatoires de la directive.

Il est toutefois indéniable que ces nouvelles dispositions considèrent des services effectivement prestés à l'intérieur du pays comme étant prestés à l'étranger, et d'autres services effectivement prestés à l'étranger comme ayant été prestés à l'intérieur du pays. La différence fondamentale entre la nouvelle et l'ancienne loi est en conséquence l'introduction de critères précis définissant le lieu où la TVA est à payer.

## II. DEFINITION DE LIEU DE LA PRESTATION

Le lieu de la prestation d'un service pour les besoins de la législation sur la TVA n'est pas nécessairement le lieu où le travail est matériellement exécuté.

En effet, la loi pose des présomptions irréfragables (article 17 nouveau de loi) suivant lesquelles sont considérés comme lieu de la prestation de service:

a) en principe le siège ou l'établissement stable à partir duquel le service est rendu,
b) par dérogation les lieux définis par l'article 17.

Ces dérogations concernent les services énumérés à l'article 9 de la directive qui sont soustraits au régime de la taxation dans le pays du siège ou de l'établissement stable de l'auteur de la prestation:

### A. Services se rattachant à un immeuble déterminé

Il importe de préciser que les prestations qui ne se rattachent pas à un immeuble déterminé, comme par exemple la confection de plans d'architecture standardisés, obéissent à la règle générale. Sont visés:

1. Les services tendant à préparer ou à coordonner l'exécution de travaux immobiliers, y compris ceux des architectes, des bureaux d'études et des bureaux de surveillance.
2. Les opérations d'entretien effectués à un immeuble, dans la mesure où elles ne constituent pas des livraisons de biens au sens de l'article 5 (par. 5.1) de la VIe Directive (art. 12f) de la loi luxembourgeoise du 12.2.1979.

**Lieu de l'imposition**

**lieu de la situation de l'immeuble**

Ce dernier assimile à une livraison la délivrance d'un travail immobilier, y compris celui comportant l'incorporation d'un bien meuble à un bien immeuble, à l'exclusion toutefois des opérations d'entretien courant. Constitueraient p.ex. des travaux immobiliers les réparations portant sur des immeubles.

3. Les prestations de services des agents immobiliers et des experts en immeubles.
4. Plus généralement tous les services en relation avec l'acquisition ou la cession d'immeubles, tels que ceux des notaires, autres services de conseils visés sous E ci-après, tels des services de publicité.
5. Les locations d'immeubles, de chambres d'hôtel, d'emplacements de parcage et de coffres-forts.
   Il y a lieu de noter que la règle s'applique à toutes les locations immobilières généralement quelconques, y comprises celles exclues de l'exonération prévue par la loi pour les locations immobilières telles que le logement passager de personnes, de stationnement passager de personnes, de stationnement passager de véhicules (v. art. 13, B, b) de la VIe Directive et art. 44.1. g) de la loi luxembourgeoise).
6. Le magasinage de biens dans un immeuble.

### B. Les prestations de transport

Pour les transports internationaux ce lieu n'est réputé se situer à l'intérieur du pays que pour la partie du transport qui y est effectivement réalisée. Signalons qu'en règle générale, les transports internationaux sont des services exonérés.

Contrairement à l'ancienne législation cette exception ne concerne pas la location de moyens de transports auxquelles s'applique la règle générale.

**Lieu d'imposition**

**lieu où s'effectue le transport**

Toutefois dans le cas où une agence de voyage a contracté en son propre nom avec un voyageur pour l'organisation d'un voyage incluant une prestation de transport effectué par un autre assujetti, le service de l'agence, même dans la mesure où il constitue l'exécution d'un contrat de transport, est taxé au siège ou établissement de l'agence. En l'occurrence la prestation en question n'est plus considérée par la loi comme opération de transport, mais comme une partie d'une prestation sui generis.

### C. Les prestations de services ayant pour objet:

1. Des activités culturelles, artistiques, scientifiques, sportives, enseignement, de divertissement ou des

activités similaires, y compris les prestations de services des organisateurs de telles activités et les prestations de service accessoires à de telles activités.
2. Des activités accessoires au transport telles que le chargement, le déchargement et la manutention ainsi que des activités similaires.

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**Lieu d'imposition**

**lieu où la partie essentielle de chaque service est matériellement exécutée**

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3. Des expertises de biens meubles corporels.
4. Des travaux portant sur des biens meubles corporels.

Dont à comprendre parmi les prestations sous 3 et 4 entre autres les simples réparations de voitures automobiles et d'autres biens meubles ainsi que les expertises y relatives (p. ex. en cas de panne).

## D. Les prestations de services ayant pour objet:

la location de biens meubles corporels que le prestataire, en vue de leur utilisation dans le pays de destination, a exportés ou importés d'un pays membre des C.E. vers un autre pays membre.

Il résulte du texte de loi que la dérogation n'est pas applicable:

a) lorsque c'est le preneur qui a exporté le bien loué d'un Etat membre vers un autre pour l'y utiliser;
b) lorsque soit le preneur soit le louer exportent le bien loué ou à louer à partir d'un pays tiers ou dans un pays tiers;
c) lorsque la location a pour objet un moyen de transport généralement quelconque dans ces trois hupothèses;

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**Lieu d'imposition**

**lieu où les biens sont utilisés**

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Dans ces quatre hypothèses le lieu de la location se détermine conformément à la règle générale (pays du loueur) sous réserve d'éventuelles mesures particulières à prendre sur base de l'habitation prévue à l'article 17 par. 3 de la loi luxembourgeoise.

En effet, cet article prévoit que le lieu de prestation pourra être fixé par référence au critère de l'utilisation ou de l'exploitation du service pour des cas où le régime décrit dans ce chapitre mène à des cas de double imposition, une non-imposition ou des distorsions de concurrence.

On constate que le texte en question ne reconnaît le critère du lieu d'utilisation que dans un cas particulier alors que dans des situations économiquement identiques le critère général reste curieusement applicable.

## E. Les prestations de services ayant pour objet:

les activités énumérées ci-après, lorsque les prestations ne sont pas visées sous A et C ci-dessus, et qu'elles sont effectuées pour le siège d'activité d'un preneur assujetti (ou de son établissement stable) établi en dehors du pays du prestataire, que ce soit dans un Etat membre ou dans un pays tiers:

1. La cession ou la concession de droits d'auteurs, de brevets, de droits de licences, de marques de fabrique et de commerce et d'autres droits similaires;
2. la publicité, y compris les prestations de services des intermédiaires en publicité agissant en leur propre nom;
3. les activités d'avoué, d'avocat, de conseiller, d'expert comptable, d'ingénieur, d'un bureau d'études ou d'activités similaires;

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**Lieu d'imposition**

**lieu du siège d'activité économique du preneur (ou de son établissement stable)**

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4. le traitement de données et la transmission d'informations;
5. les opérations bancaires, financières, d'assurance et de réassurance à l'exception de la location de coffres-forts;
   Signalons que les opérations de banque et d'assurances proprement dites sont exonérées.
6. la mise à disposition de personnel;
7. les prestations de services consistant dans l'obligation de ne pas exercer, entièrement ou partiellement, une activité professionnelle ou un droit visé ci-dessus sous 5;
8. les prestations de services des intermédiaires qui agissent au nom et pour le compte d'autrui et qui interviennent dans les prestations de services visées ci-dessus sous 5.

## F. Les prestations de services:

énumérées sous E ci-dessus, qui ne sont pas visées sous A et C et qui sont effectuées pour les besoins d'un preneur *non assujetti* domicilié ou résident habituellement *en dehors des C.E.*

Remarques quant aux positions 5 et 6 ci-dessus:

Il résulte implicitement du texte que:

1. les mesures dérogatoires énumérées sous 5 et 6 ci-dessus sont primées par celles figurant sous 1 et 3. Il y a lieu de signaler qu'elles peuvent être modifiées ou complétées par des dispositions particulières sur base de l'habilitation contenue dans la loi.
2. dans l'hypothèse où le prestataire et le preneur sont établis dans le même pays le lieu des prestations sous 5. est fixé d'après le principe général (lieu d'établissement du prestataire)
   Il en est de même lorsque le preneur non assujetti a son domicile ou sa résidence habituelle à l'intérieur des C.E.

**Lieu d'imposition**

**lieu du domicile ou de la résidence du preneur**

3. En d'autres termes et en résumé:
   (a) C'est le lieu d'établissement du preneur qui détermine le lieu de la prestation
   (i) dans tous les cas où le preneur est établi dans un pays tiers
   (ii) en cas d'établissement à l'interieur des C.E., seulement lorsque le preneur est un assujetti et que le siège de son activité ou son établissement stable se trouve dans un pays-membre autre que celui du prestataire, peu importe que ses activités soient possibles ou non de la TVA.
   (b) Au contraire le lieu d'établissement (d'activité) du prestataire sera considéré comme lieu de la prestation lorsque
   (i) le preneur et la prestataire sont établis dans le même pays
   (ii) le preneur est un non assujetti ayant son domicile ou sa résidence dans un autre pays membre des C.E.

   Pour éviter les cas de non-imposition, le par. 3 de l'article 17 habilite le Gouvernement à déroger aux dispositions des par. 1er et 2 (positions 1 à 6 ci-dessus) en ce qui concerne la location de biens corporels, y compris les moyens de transport, et les prestations visées sous 5 et 6 ci-dessus, en fixant le lieu de ces prestations par référence au critère de l'utilisation ou de l'exploitation.

## III. LES OBLIGATIONS DU PRESTATAIRE DES SERVICES

### A. Services effectués au lieu du siège ou d'un éstablissement stable

Pour le prestataire dont les services sont réputés avoir été rendus à l'intérieur du pays, en raison de l'existence à l'intérieur du pays du siège d'activité ou d'un établissement stable, le régime d'importation n'a pas changé. Le prestataire devra être immatriculé auprès de l'administration compétente et déposer ses déclarations comme par le passé.

Il est indéniable que le principe de la taxation au lieu du siège ou de l'établissement, à partir duquel le service est presté, simplifie beaucoup la perception de la taxe en ce que les opérations ne seront désormais plus exonérées dans le pays du siège du prestataire et plus soumises à la TVA dans le pays où le service est utilisé.

### B. Services énumérés à l'article 9 par. 2 sous (E) de la Directive

En ce qui concerne certains services énumérés plus spécialement à l'article 9 par. 2 sous (E) de la Directive, l'article 21 de celle-ci a prévu un système simplifié:

En effet, pour:
— les cessions ou concessions de droits d'auteurs, brevets, licences, marques de fabriques ou de commerce et droits similaires,
— la publicité,
— les activités d'avoué, d'avocat, de conseiller d'expert comptable, d'ingénieur, d'un bureau d'études et les activités similaires,
— le traitement de données et la transmission d'informations,
— les opérations bancaires, financières, d'assurance et de réassurance (excepté la location de coffre-forts),
— la mise à disposition de personnel,
— l'obligation de ne pas exercer une activité professionnelle ou un droit quelconque visé ci-dessus,
— les prestations d'intermédiaire agissant au nom et pour le compte d'autrui et intervenant dans les prestations ci-dessus,

la directive prévoit que le preneur de la prestation sera le débiteur de la taxe, tandis que le prestataire peut être rendu solidairement responsable.

Puisque le preneur en question doit nécessairement être assujetti à la taxe dans son pays, cette solution a le mérite de sembler pouvoir s'appliquer sans difficulté: en effet le preneur sera obligé de déclarer la prestation de service dans ses propres déclarations, et par voie de conséquence devrait normalement pouvoir procéder à la déduction de la taxe ainsi déclarée.

Toutefois, le degré de difficulté dans l'application de ce principe devient plus élevé lorsqu'il faut demander des déclarations à des milliers d'assujettis non immatriculés ne faisant que des prestations exonérées.

Au Grand-Duché, pareille obligation du preneur n'est pas encore inscrite dans un texte formel. En effet, l'article 26 de la loi nouvelle prévoit qu'un règlement grand-ducal pourra disposer que la taxe sera due par le preneur du service sous la responsabilité solidaire du prestataire. A ce jour aucun règlement n'a été pris en ce sens.

### C. La pratique administrative

En pratique, à défaut de texte règlementaire pris sur base des habilitations prévues par la loi, rien n'est changé dans la procédure de taxation des services censés effectués au Grand-Duché par des assujettis étrangers par rapport à la taxation des services antérieurement effectués à l'étranger et utilisés au Grand-Duché.

La première obligation du prestataire est celle de la déclaration de l'opération. En principe une déclaration doit être faite dès le commencement de l'opération (article 61 al. 1 de la loi organique) et une autre déclaration indiquant le montant de la taxe due, doit être déposée dans les quinze jours du deuxième mois suivant celui lors duquel l'opération a été faite (où en cas de paiements de la rémunération par acomptes pour une opération prolongée dans les 15 jours du mois suivant l'établissement de la facture afférente à chaque acompte). Il y a lieu de signaler que par toute opération faite avec un contractant assujetti, le prestataire doit délivrer une facture mentionnant le montant de la taxe due dans les 25 jours du mois suivant celui où l'opération a été faite.

La première déclaration est généralement faite par information écrite à l'Administration de l'Enregistrement à Luxembourg. Cette information est transmise au bureau d'imposition X chargé de la récupération des taxes dues par des prestataires étrangers. Le fonctionnaire compétent se met alors en rapport avec l'assujetti pour définir la façon appropriée de procéder. En cas de services purement occasionnels, l'assujetti étranger n'est pas immatriculé mais déclare le service par simple lettre. L'Administration peut aussi convenir avec lui de se mettre en rapport avec le preneur pour que celui-ci déclare à décharge du prestataire.

Après réception d'une déclaration pour service purement occasionnels, l'Administration établit un titre de recette sur base duquel la taxe est perçue.

En cas de services occasionnels, il arrive assez fréquemment que le preneur fasse la déclaration à décharge du prestataire et se charge lui-même de l'acquittement de la taxe. Le prestataire pourra également demander à son cocontractant de se charger de ces formalités, ce qui toutefois n'a un intérêt que si le preneur est effectivement tenu de déposer des déclarations, s'il fait donc lui-même des opérations non-exonérés. En effet, vis-à-vis de l'Administration le prestataire reste celui qui est personnellement tenu de déposer les déclarations, et en cas d'oubli du cocontractant, le prestataire s'expose aux sanctions.

Il appartient au receveur compétent de vérifier si la prestation a un caractère occasionnel. Dans le cas contraire, il procédera à l'immatriculation du prestataire. En cas de prestations de services importants et continuels, il demandera la nomination d'un représentant responsable (qui souvent est le preneur solidairement responsable) ou plus généralement un cautionnement.

Les obligations du représentant responsable sont celles d'établir les déclarations, de détenir aux fins de contrôle les copies des factures et toutes pièces nécessaires à cette fin. Par ailleurs, il garantit solidairement le paiement de la taxe et des amendes. Toutefois, c'est le prestataire qui établit les factures indiquant le montant de la taxe dont il devra transmettre une copie au représentant responsable.

Par arrêté grand-ducal du 22 décembre 1979 pris sur base de l'article 63 2 sous (E) de la loi organique, l'administration est autorisée à demander le dépôt d'un cautionnement auprès de la Caisse de Consignation ou une garantie bancaire destinée à assurer le paiement de la taxe. Les montants sont fixés par le préposé en fonction de l'importance présumée des opérations imposables et de la créance de l'Etat. Cette pratique est généralement préférée à celle de la nomination de représentant responsable.

## IV. PROCEDURE DE DEDUCTION DE LA TAXE EN AMONT ET PROCEDURE DE REMBOURSEMENT PREVUE PAR LA 8E DIRECTIVE

La 8ième directive adoptée par le Conseil prévoit l'introduction par les Etats-membres d'un texte permettant le remboursement de la taxe à des preneurs de services assujettis non établis dans le pays qui a perçu la taxe.

Il y a d'abord lieu de signaler que le texte en question ne s'applique que dans le cas où l'assujetti concerné ne fait pas lui-même d'opération imposable dans le pays où la taxe a été prélevée. Dans le cas contraire, il pourra récupérer la taxe ayant grevé des services qui lui ont été rendus par le biais de la déduction de la taxe en amont et éventuellement la restitution de l'excédent de la taxe en amont. Il faut toutefois que l'assujetti ait lui-même fait la déclaration de ses propres prestations, et il ne pourra récupérer la taxe en amont s'il a demandé au preneur de déclarer à décharge. En pratique le texte nouveau ne visera donc que des cas exceptionnels. A cette fin, la loi organique a habilité le gouvernement à introduire cette procédure par voie de règlement.

Alors que la directive a défini le modèle de la demande de remboursement à remplir pour l'assujetti concerné et les pièces et attestations qui sont à joindre, et en raison de la centralisation des services de l'Administration au Grand Duché le nouveau texte devra pouvoir s'appliquer sans difficultés.

Il y a lieu de rappeler que la directive prévoit que l'assujetti étranger devra justifier sa qualité d'assujetti par une attestation de son administration locale et joindre les originaux des factures ou documents d'importation. La demande sera à adresser à l'Administration avec les pièces à l'appui définis ci-haut.

Eu égard aux expériences pratiques que l'on a pu faire dans les rapports avec l'Administration de l'Enregistrement, il est à prévoir que l'assujetti ayant rempli ces formalités simples, ne rencontrera pas de difficultés pratiques pour récupérer le montant de la taxe, qui lui sera viré normalement dans les quelques semaines suivant le dépôt de la déclaration.

## Réflections

# COMMUNAUTE EUROPEENNE:

## Monsieur GUIEU

L'orateur commence par retracer la genèse des travaux de la Commission sur la taxation des prestations de services en disant que c'est une lourde tâche d'essayer d'indiquer tous les méandres des discussions qui ont abouti à ce texte de compromis de la 6ème directive qui a pu rallier l'adhésion de tous les Etats membres. Il s'agit bien d'un texte de compromis qui peut-être présente certaines difficultés d'application au plan national.

Dans le cas des prestations de services, il existait des situations fort différentes. Lorsqu'on a adopté la 2ème directive T.V.A. en avril 1967, on avait cru qu'au plan communautaire (six pays à l'époque), la solution idéale et uniforme avait été trouvée en prévoyant que le lieu de la taxation de services serait le lieu d'utilisation. On espérait pouvoir éviter les doubles impositions et les non-impositions qui s'étaient présentées dans les situations précédentes.

Malheureusement ce critère d'utilisation avait un champ très restreint puisqu'il ne s'appliquait que pour les prestations de services énoncées dans l'annexe B de cette deuxième directive et c'étaient les prestations de services qui théoriquement étaient le plus souvent incorporées dans le prix des marchandises, qui avaient donc les influences dans les relations internationales; d'autre part, les Etats membres avaient encore la possibilité d'exonérer ces prestations de services, bien que citées dans l'annexe B.

Il faut ajouter qu'en raison de situations différentes de pays à pays, il y avait aussi un correctif: l'annexe accordait aux Etats membres la possibilité de déroger à ce principe de la taxation dans le lieu de l'utilisation, mais sous réserve d'éviter les cas de double imposition.

Autre difficulté constatée: certains Etats membres ont interprété d'une façon différente la notion d'utilisation. Pour des raisons pratiques, certains pays ont estimé que le lieu d'utilisation était le lieu du prestataire de services: dès que le prestataire rendait sa prestation, il y avait commencement d'utilisation. D'autres pays, au contraire, se référaient au lieu du preneur, c'est-à-dire au lieu où le preneur recevait la prestation. Dans un troisième groupe de pays, ce n'étaient ni le lieu du preneur, ni le lieu du prestataire, mais le lieu d'utilisation réelle: là où le bien était réellement utilisé.

Il en résultait que l'application brutale de ces principes devait conduire à des cas de double, voire de triple imposition, ou à des cas de non-imposition.

Mais pour éviter ces inconvénients, chacun des Etats membres avaient établi toute une série de dérogations de sorte que les législations traitant notamment de la détermination du lieu de taxation des prestations de services étaient très compliquées et nullement comparables de pays à pays.

En fonction de cette situation de fait qui avait évolué sur un texte communautaire — et l'on pensait que la question était résolue — les services de la Commission se sont mis au travail. Après de longues discussions avec les experts, la Commission avait essayé dans sa proposition de 6ème directive d'écarter la notion d'utilisation pour se concentrer uniquement sur la notion du prestataire de services.

Dans les propositions présentées au Conseil, on avait demandé aux Etats membres de prévoir que le lieu de la prestation de services était, pour toutes les prestations de services, le lieu du prestataire de services.

Mais il fallait un correctif pour éviter des cas de double imposition si la prestation de services était utilisée par un preneur assujetti dans un autre Etat membre avec une notion d'exportation de services: à ce moment-là, bien que l'assujetti soit le prestataire, il y avait, comme pour les marchandises, une notion d'exportation et de taxation dans le lieu de l'obtention dans le chef du preneur.

On avait ainsi un système parallèle à celui existant pour les marchandises et, avantage le plus important, une unicité du lieu de la prestation de services quelle que soit la situation de l'utilisateur.

A ce critère du prestataire de services, il y avait malheureusement deux exceptions: l'une pour les immeubles, et c'était le lieu de la situation de l'immeuble, l'autre pour les transports, c'était le lieu de la prestation de services en fonction du parcours du transport.

Dans le texte retenu de la 6ème directive, on a toujours le principe général de l'art. 9/1, qui prévoit la taxation auprès du prestataire de services. Cela permet de régler déjà toutes les prestations de services rendues à des non assujettis ou à des particuliers. On est ainsi assuré d'un lieu unique de taxation, sans possibilité d'y échapper et en évitant toute double taxation.

Par contre, si les Etats membres ont accepté de conserver l'exception prévue pour les immeubles et les transports, ils ont ajouté de nouvelles dérogations à ce principe pour notamment les activités culturelles, les activités accessoires au transport, les expertises portant sur les biens meubles corporels et surtout sur les travaux portant sur les biens meubles corporels en prévoyant que pour ces prestations de services, le lieu de la prestation était l'endroit où était matériellement exécutée cette prestation de services.

C'était déjà là une dérogation assez substancielle au principe du lieu du prestataire de services.

Il y a eu enfin une autre dérogation qui aboutit dans les faits au résultat que l'on avait recherché dans la notion d'exportation de services, c'est l'art. 9/2 litt.e, où il est prévu que pour toutes les prestations de services, qui sont incorporées dans le prix des biens en principe, comme les concessions et droits d'auteur, les prestations de publicité, les obligations de ne pas exercer une activité, les opérations financières, etc..., le lieu de la prestation devenait le lieu du preneur lorsque le preneur dans la Communauté était un assujetti; il en était de même si le preneur était situé hors de la Communauté (assujetti ou non). De sorte que pour ces prestations de services nous risquons d'avoir deux lieux de la prestation de service selon la situation du preneur.

En régime normal, à l'intérieur d'un Etat membre, pour ces prestations de services, le lieu de la prestation de services est toujours situé auprès du prestataire; c'est lui qui va facturer, c'est lui qui va transmettre la taxe à son preneur, et c'est lui qui est redevable de la taxe; par contre, si le preneur est un assujetti communautaire, mais qui est situé dans un autre pays, le prestataire se trouve hors du champ d'application de la T.V.A. et c'est le lieu du preneur qui prévaut. Ceci entraîne pour une même opération rendue par un prestataire de service deux lieux de la prestation de services.

Dommageable intellectuellement, cette situation est valable au point de vue économique, puisque ces prestations de services sont taxées auprès du preneur, au taux du preneur et permettent, surtout au preneur, de déduire la taxe pour éviter toute rémanence de taxe. On arrive ainsi à éviter des doubles impositions.

Cette conception dualiste des prestations de services énumérées à cette disposition a paru néanmoins fort regrettable aux instances communautaires.

Un correctif a cependant été apporté en ce qui concerne les prestations de services qui sont rendues à des assujettis hors communauté et dont le lieu de la prestation de services est situé auprès de ce preneur. La conception de l'utilisation a été introduite pour éviter prestations de services, les Etats membres peuvent demander qu'une autre personne soit également redevable de la taxe: un représentant ~~fiscal~~ ou le client preneur.

Par contre, pour toutes les prestations de services qui sont fixées à l'art. 9/2,e (toutes les opérations pour lesquelles le lieu de la prestation de services est le lieu du preneur), il n'y a qu'une seule personne qui est redevable de la taxe, c'est le preneur.

En ce qui concerne les moyens de récupérer ou de rembourser cette taxe, le mécanisme qui a été instauré par la 6ème directive aboutit pratiquement dans tous les cas à la récupération totale de la taxe. Ou bien le redevable de la taxe est le preneur et il est mis en cause comme redevable soit à titre subsidiaire, soit à titre principal. A ce moment-là, il est évident qu'il peut utiliser les dispositions de l'article 17 pour déduire la taxe qui a frappé la prestation de services et par conséquent, dans son chef, il ne peut pas y avoir de rémanence de taxe. Par contre, si le prestataire est également redevable de la taxe étant donné qu'il a des opérations imposables, il a le droit également de déduire la taxe qui a frappé ses opérations en amont.

Selon l'orateur, l'article 17/4, c'est-à-dire le remboursement de la taxe à un assujetti étranger et la 8ème directive ne sont valables que si le prestataire établi à l'étranger a recours à des fournisseurs dans le pays de la taxation pour sa propre prestation de services. Il estime que la 8ème directive ne joue pas pratiquement dans le contexte de la prestation de services et du lieu de la prestation de services tels que définis dans l'art. 9 de la 6ème directive.

Il conclut en disant que ce texte de la directive résulte d'un compromis, mais aboutit quand même au résultat recherché qui est d'éviter des cas de non-imposition et de double imposition. Il rend parfois les situations un peu complexes et mériterait qu'on réfléchisse par la suite pour essayer de regrouper sur la notion du lieu du prestataire de services certaines opérations qui sont à l'heure actuelle au lieu du preneur ou à l'endroit où les prestations sont matériellement exécutées.

Il convient de remarquer que si ces règles se sont, au fil des discussions, un peu compliquées, cela provient également de la différence du niveau de taxation des prestation de services. Certaines délégations, à juste titre parfois, ont eu la crainte de voir des détournements de prestations de service vers des pays qui avaient un niveau plus bas si on prévoyait uniquement la règle de la taxation dans le chef du prestataire de services.

## BELGIQUE:

### M. CAPPELLEMAN

Après les exposés très clairs de M. Guieu et de M. Le Brun, l'orateur essaiera de décrire les quelques problèmes que l'on a en matière d'application de l'article 9 de la 6ème directive en suivant la présentation qui est faite à ce sujet dans le Code belge de la T.V.A.

En Belgique, on a suivi d'assez près le libellé de la 6ème directive encore qu'avant le 1er janvier 1978 déjà, le critère selon lequel la taxe est perçue dans le pays du preneur (art. 21) ait connu de nombreuses applications.

Dans son paragraphe 1er, cet article précise qu'une prestation de services a lieu dans le pays lorsque le lieu où elle est réputée se situer conformément aux paragraphes qui suivent se trouve dans le pays, ce qui n'est peut-être pas des plus clair ou qui est peut-être trop clair mais qui en toute hypothèse en soi ne résoud rien.

Les critères, on les rencontre à partir du paragraphe 2, et ici se trouve le critère principal, le critère du lieu du prestataire.

En fait le lieu du prestataire, ce n'est peut-être pas nécessairement le lieu où est établi le prestataire mais en fait c'est l'endroit où le prestataire de services a établi le siège de son activité professionnelle ou un établissement stable à partir duquel la prestation de services est rendue. Dans la pratique, l'application de ce critère n'a pas donné lieu à des problèmes majeurs.

Dans le cas cité par M. Le Brun, on peut se demander où se situe le lieu à partir duquel la prestation de services est rendue: est-ce là où en fait le matériel est importé, est-ce là où le matériel est régulièrement donné en location à partir d'un lieu donné en France? On peut effectivement se demander si le lieu où le matériel se trouve ou le lieu où il rentre régulièrement en vue d'être donné en location ne peut pas constituer un lieu pour la prestataire de services qui y a établi un siège d'activité. C'est effectivement une question. Si la proposition de 10ème directive était réalisée, ce problème serait résolu mais cette proposition n'est pas réalisée, je n'oserais même pas dire qu'elle sera réalisée dans un proche avenir.

Voilà le critère principal: le lieu du prestataire.

Il y a une série d'exceptions: d'abord l'endroit où est situé l'immeuble lorsqu'il s'agit d'une service qui est relatif à une immeuble par nature, auquel cas le lieu du service est le lieu où se trouve l'immeuble.

Les cas d'application de ce critère sont fixés dans l'arrêté royal no. 5 et une énumération très rapide nous démontre qu'en fait il s'agit de tout travail immobilier, c'est-à-dire tout travail de construction, de démolition, d'entretien d'immeuble, etc., également tout travail d'étude et de contrôle qui relève de l'activité habituelle des architectes, des ingénieurs et des géomètres, toute expertise portant sur un immeuble par nature, toute mise à disposition d'emplacement ou parking, ou pour l'entreposage de biens, toute prestation d'hôtellerie en tant que mise à disposition d'une chambre, toute mise à disposition d'emplacement sur un terrain de camping. Il en est encore ainsi de toute location de coffres-forts qui sont immeubles par nature ou de toute location de biens immeubles par nature; on sait qu'en Belgique, uniquement ce qu'on appelle le leasing immobilier est soumis à la T.V.A., mais non les locations ordinaires d'immeubles.

Il existe une nouveauté par rapport à la situation qui existait auparavant: toute intervention comme intermédiaire lors de la constitution, de la cession d'un droit réel ou de jouissance sur un bien immeuble par nature, toute intervention d'une agence immobilière en tant que courtier dans la location ou de vente d'un immeuble est soumise à la T.V.A. en Belgique, dès que l'immeuble donné en location ou vendu se situe en Belgique.

Enfin toute gestion d'un bien immeuble par nature situé en Belgique est également soumise à la T.V.A.

Deuxième dérogation: l'endroit où se trouve le bien lorsqu'il s'agit d'un travail, y compris l'expertise, portant sur un bien meuble. Cela signifie que tous les travaux à effectuer sur des biens meubles se trouvant en Belgique sont soumis à la T.V.A. en Belgique.

Bien sûr, lorsqu'un bien est importé en Belgique en vue d'être travaillé à façon et ensuite réexporté (perfectionnement actif), en principe ce travail est soumis à la T.V.A. belge, sauf exonération lorsque le bien travaillé est réexporté ou est exporté par le travailleur à façon dans les conditions prévues pour l'exonération en cas d'exportation par le fournisseur du service.

Pour l'expertise, si elle est effectuée sur un bien meuble qui se trouve en Belgique, la T.V.A. est due en Belgique. On s'est déjà interrogé sur la question de savoir, quand on parle de travail, si on ne vise que les travaux matériels, ou également les travaux intellectuels. Quand on compare le texte belge avec la directive, on constate dans la directive qu'il est question de travaux, et l'orateur se pose la question de savoir si le mot travail veut dire travail matériel ou s'il a une signification plus large en fait.

La troisième dérogation concerne les transports, le lieu d'une prestation de transport et donc le lieu où le transport est effectué et en fonction des distances parcourues. Rien de particulier quant à cette dérogation.

La quatrième dérogation précise que le lieu du service c'est l'endroit où la prestation de services est matériellement exécutée lorsque cette prestation a pour objet des activités culturelles, artistiques, sportives, scientifiques, d'enseignement, de divertissements ou similaires. M. Le Brun, en ce qui concerne le lieu du service, a fait état d'une question relative à la taxation de prestations de services ayant pour objet la formation de personnel qui allait de pair avec une vente de matériel à exporter, enseignement qui est donné par le fournisseur de ce matériel. Selon l'orateur, il est clair que le lieu du service est le lieu où cet enseignement est donné et ce, sur base du texte; mais comme il y avait exportation du matériel, auquel cet enseignement se rapporte, on considère que cet enseignement est exonéré pour des raisons d'exportation. C'est une solution qui parait tout à fait compatible avec la 6ème directive encore qu'en Belgique on ne va pas aussi loin semble-t-il, étant donné que le texte en matière d'exportation énumère limitativement les prestations de services qui sont exonérées comme se rapportant à des biens exportés, texte dans l'énumération duquel on ne retrouve pas ce genre de prestations.

Selon M. Cappelleman, si une situation pareille devait se produire en Belgique, on devrait dire que la T.V.A. est due en Belgique. Mais ceci ne veut pas dire que si la T.V.A. belge est portée en compte par le fournisseur du bien prestataire d'enseignement à une société étrangère, que celle-ci doive supporter cette T.V.A. définitivement; la société étrangère peut récupérer la T.V.A. belge dans des conditions que l'on va pouvoir exposer dans le courant de l'après-midi.

Les prestations des restaurateurs, des cafetiers se situent également là où le cafetier et le restaurateur se trouvent. Lorsqu'il s'agit de prestations accessoires au transport, c'est également le lieu du service qui est le lieu où la prestation est matériellement exécutée.

On s'était interrogé au sujet de certaines prestations accessoires au transport, c'est-à-dire essentiellement des opérations de chargement et de déchargement; mais il y en a encore d'autres qui ont été citées par M. Le Brun, notamment le jaugeage et le pesage. Là aussi on applique le critère du lieu où la prestation est matériellement exécutée.

En Belgique, on s'était demandé s'il fallait suivre le même critère pour ce qu'on appelle la réception des marchandises, réception qui consiste assez souvent en un contrôle quantitatif ou qualitatif des marchandises, ou une prise d'échantillons, prestations confirmées par un bordereau de réception de marchandises. On a décidé, dans ce cas, qu'on doit appliquer le critère qui vaut pour la prestation accessoire au transport, mais il faut ajouter que dans ce domaine il y a généralement exonération lorsqu'il s'agit de prestations qui se rapportent à des marchandises exportées ou importées.

Le critère suivant est l'un des plus contesté, à savoir le critère concernant la location.

Lorsqu'il s'agit d'un bien meuble autre qu'un moyen de transport, le critère à suivre, c'est le lieu du prestataire sauf, selon le Code belge, lorsque le bien est donné en location par un loueur qui est établi dans la Communauté et qui exporte le bien dans un autre pays de la Communauté, où le bien sera utilisé. On voit bien apparaître ici la notion d'utilisation et cette disposition est tout à fait conforme à la 6ème directive; et, deuxième exception, ce n'est pas le lieu du prestataire, c'est le lieu de l'utilisation lorsque le bien est donné en location par un loueur qui est établi hors de la Communauté européenne.

En fait, le lieu du prestataire connaît une double exception: cas du bien exporté par le loueur dans un autre pays du Marché Commun où le bien serait utilisé, et cas où le loueur est établi hors de cette Communauté.

Quelques problèmes ont surgi en Belgique en raison de l'application de la 6ème directive. On est conscient de ce que le résultat obtenu n'est pas toujours équitable. Mais si on veut précisément éviter des doubles impositions ou des non impositions, il semble nécessaire d'appliquer pratiquement à la lettre les dispositions de la 6ème directive à ce sujet.

Cela peut parfois conduire à des situations assez curieuses. On a par exemple, en Belgique, un cas dans lequel une société néerlandaise achète aux Pays-Bas du matériel qu'elle donne en location à une société belge et dès lors ce matériel est exporté par le fournisseur du matériel à la demande du loueur directement des Pays-Bas en Belgique. Dans ce cas, le lieu de la prestation de services, ce n'est pas les Pays-Bas étant donné que le matériel est exporté par le loueur ou sur son ordre des Pays-Bas en Belgique, et la T.V.A. est due en Belgique. Mais malheureusement ce n'est pas tout. Ce même loueur achète également du matériel en Belgique qui sera donné en location en même temps que le matériel qui est importé des Pays-Bas, et pour compliquer les choses, la location se fait pour un prix unique.

Pour la première partie, à savoir pour le matériel qui est envoyé des Pays-Bas en Belgique, on l'a dit, le lieu du service est la Belgique, étant donné que l'on se trouve dans la première exception: matériel qui est exporté par le loueur à destination d'un autre pays du Marché Commun où le matériel sera utilisé. Pour la deuxième partie, il s'agit de marchandises qui sont achetées en Belgique et qui restent en Belgique: il n'y a donc pas de déplacement de la marchandise d'un pays vers un autre: dès lors il faut appliquer le critère normal, c'est le lieu du prestataire, et on devrait dire que la T.V.A. est due aux Pays-Bas.

L'orateur signale que la décision n'est pas sortie, mais croit savoir que si la Commission avait été consultée, la réponse aurait été que, compte tenu de la proposition de 10ème directive, la taxation devrait avoir lieu en Belgique. Mais tant qu'il s'agit d'une proposition de directive, il semble que l'on doive s'en tenir au texte pour le moment, même si le texte conduit à une solution baroque.

Autre exception à la règle: le critère relatif aux moyens de transport.

Selon la 6ème directive, le lieu du service est le lieu du prestataire, c'est-à-dire le lieu à partir duquel en fait la prestation de services est effectuée.

Mais la 6ème directive, notamment en ce qui concerne les locations de biens meubles, permet de déroger à cette règle fondamentale mais seulement dans deux cas: le premier cas, est celui dans lequel le lieu du service se situe à l'intérieur de la Communauté mais où l'utilisation du bien se fait en dehors de la Communauté: dans ce cas, on aura évidemment toute faculté de déroger à la règle principale; le deuxième cas, c'est exactement l'inverse: si, selon la règle principale de la directive, le lieu de la prestation se trouve en dehors de la Communauté et s'il y a en fait utilisation effective du bien dans la Communauté, les Etats membres ont la faculté de situer le lieu là où s'exerce l'utilisation.

En Belgique, le législateur a fait usage directement de cette faculté, en disposant que pour la location de moyens de transport, si la règle principale est le lieu du prestataire, il y a une double exception, savoir: (1) le lieu du service c'est le lieu d'utilisation lorsque le moyen de transport est donné en location par un loueur qui est établi dans le pays; et (2) le lieu du service est seulement situé là où s'exerce l'utilisation dans la mesure où le moyen de transport est utilisé en dehors du Marché Commun. Ce n'est d'ailleurs que dans ces limites là que les Etats membres peuvent faire usage de la faculté laissée par la 6ème directive.

Voici un exemple concret: si l'on prend en location en Belgique un véhicule pour faire un voyage en Europe, en principe la T.V.A. est due en Belgique sur le loyer total; mais dans la mesure où la voiture est utilisée en dehors du Marché Commun, le loyer n'est pas imposable en Belgique. Il n'est pas facile de dire au départ dans quelle mesure le véhicule sera utilisé à l'intérieur du Marché Commun ou à l'extérieur du Marché Commun.

Les Etats membres qui n'ont pas fait usage de cette faculté s'y retrouvent peut-être plus facilement, parce que dans ce cas le loyer peut être taxé intégralement.

D'autre part, si le véhicule est donné en location par un loueur établi hors de la Communauté, le lieu d'utilisation se situe là où le véhicule est utilisé. Si jamais un touriste qui a pris en location un véhicule en dehors du Marché Commun, pénètre avec ce véhicule en Belgique, il est probable que l'on aurait quelques problèmes pour percevoir la T.V.A. à concurrence de l'utilisation du véhicule dans le pays.

Revenons à une dernière exception à la règle principale (lieu du prestataire), exception selon laquelle le lieu du service est le lieu du preneur dans les cas déjà décrits par MM. Guieu et Le Brun, c'est-à-dire seulement lorsque le preneur est établi en dehors de la Communauté ou lorsqu'il est établi dans la Communauté, dans un autre pays que la Belgique, bien entendu, et lorsqu'il agit pour les besoins de son entreprise.

Ceci demande un mot d'explication: la directive parle d'un assujetti, à propos de la distinction entre le preneur établi en dehors de la Communauté et le preneur établi dans la Communauté mais qui a alors la qualité d'assujetti. Or dans le Code belge, on ne parle pas d'assujetti mais d'un preneur qui agit pour les besoins de son entreprise. La raison en est qu'en Belgique un assujetti est celui qui supporte effectivement le poids des formalités en matière de T.V.A.; dès l'introduction de la T.V.A., on a eu des réticences pour décider qu'une entreprise exonérée, par exemple, était assujettie à la T.V.A.

En Belgique, la qualité d'assujetti est donc réservée aux entreprises qui, effectivement, ont des obligations en matière de T.V.A., des obligations actives. Pour la directive, ce n'est pas le cas: une clinique, un institut d'enseignement, etc. sont des assujettis. Or l'expression contenue dans le texte belge "le preneur qui agit pour les besoins de son entreprise" doit se comprendre dans le sens d'assujetti selon la 6ème directive et c'est bien dans ce sens là que cette disposition est appliquée.

Le lieu des services est au lieu où est établi le preneur, lorsqu'il s'agit de concessions, droits d'auteur, concessions de clientèle, travaux de publicité. On interprète ceux-ci dans un sens très large en Belgique: on y comprend par exemple les annonces faites en vue de la vente d'un immeuble ou en vue de recrutement du personnel, on ne fait pas de distinction. Pour les annonces qui sont faites en vue de la vente d'un immeuble, on s'était bien demandé si on ne devrait pas dire qu'il s'agit d'une prestation de services se rapportant à un immeuble. C'est une question, mais puisque les travaux de publicité sont nommés expressément, on a estimé qu'il fallait les comprendre ici dans cette catégorie.

Il faut encore citer les travaux de nature intellectuelle fournis dans l'exercice de leur activité habituelle par les conseillers juridiques ou autres, les experts comptables, les ingénieurs, les bureaux d'études, etc. C'est une disposition qu'on applique d'une façon assez large également aux études de marché, par exemple à la communication de renseignements commerciaux tels la communication de listes de clients possibles. On applique cette disposition d'une manière assez large parce que normalement ce genre de services est commandé par des assujettis pour les besoins de l'entreprise. Si on ne devait pas appliquer ce critère et si on devait donc taxer dans le pays du prestataire il y aurait tout de même lieu à récupération de la T.V.A. par le biais de l'art. 17, 4º: un assujetti étranger peut toujours récupérer la T.V.A. en Belgique, du moment qu'il prouve qu'il a fait des dépenses pour l'exercice de son activité d'assujetti. Dans le doute, on préfère dire qu'on ne perçoit pas pour éviter la procédure de restitution qui peut être assez longue.

Enfin le lieu du preneur sert de critère pour les services des banques et des autres organismes financiers, toujours dans les mêmes limites quand il s'agit de prestations de services faites pour des preneurs établis en dehors du Marché Commun ou établis dans un autre pays du Marché Commun, mais qui agissent pour les besoins de leur entreprise. Il en est de même pour la mise à disposition de personnel ou pour les services fournis par les courtiers mandataires qui interviennent dans des opérations déjà énumérées, c'est-à-dire dans les concessions de brevet, dans la publicité, dans les travaux de nature intellectuelle, etc. Là aussi il y a en Belgique par rapport à la situation précédente un changement assez fondamental.

M. Cappelleman termine son exposé en disant qu'il croit ainsi avoir situé la question dans certains cas et qu'à sa connaissance on ne connaît pas trop de problèmes avec l'article 21 du Code belge.

## FRANCE:

### MONSIEUR LEBRUN

L'idée de base de la Commission est une idée née de la constatation des difficultés qui résultaient du concept d'utilisation des services. Il était en effet relativement satisfaisant pour l'esprit de se tourner vers une notion différente, vers une notion juridique, la notion du preneur ou la notion du prestataire.

L'inconvénient est que les notions juridiques collent parfois mal avec la réalité de ce que doit être un impôt sur la consommation. L'on ne doit jamais oublier qu'en la circonstance, les entreprises sont, certes, redevables de l'impôt mais que le poids final se porte sur le consommateur. C'est en quelque sorte cette approche réaliste et nécessairement fiscale — dans le sens de moyens de financement du budget — qui était la préoccupation des Etats.

En guise d'exposé introductif, l'orateur explique les raisons pour lesquelles les délégations n'ont pas toujours pu suivre la Commission dans son approche théorique et pourquoi elles ont contribué à ce que Monsieur GUIEU peut appeler un compromis.

L'on n'a pas toujours pu suivre la Commission dans les propositions dont la valeur et l'articulation ne sont pas contestables. D'autre part, on se trouvait en présence de difficultés dès lors que les prestations encourues sont des prestations qui peuvent non seulement être juridiquement établies au nom de prestataires ou de preneurs établis dans la Communauté, mais également au nom de prestataires ou de preneurs établis dans des pays hors Communauté. Cette préoccupation n'était pas négligeable.

Au plan pratique, comment les administrations ont-elles réagi devant un certain nombre de difficultés?

Le premier problème, c'est la définition de certains services énumérés à l'article 9 de la directive qui ne sont pas imposables à la taxe sur la valeur ajoutée dans le pays où le prestataire est établi.

Essentiellement, de quels services s'agit-il? Il s'agit des locations de biens meubles corporels, des services se rattachant aux immeubles, des services se rattachant aux transports, d'un certain nombre de prestations intellectuelles et des opérations portant sur les cessions ou concessions de droit d'auteur notamment.

En ce qui concerne les locations de moyens de transport, on n'a pas rencontré de difficultés fondamentales. On est peut-être en face, à l'heure actuelle, d'une difficulté qui est liée, elle, à la définition du domicile de l'assujetti, de l'établissement stable.

On est souvent interrogé et amené à s'interroger sur la situation dans laquelle une location de moyens de transport effectuée d'une manière définitive en France par une entreprise établie dans la Communauté doit être ou non imposable en France.

Les circonstances de fait qui caractérisent cette situation sont déterminantes: l'importation définitive du moyen de transport en France, son rattachement en permanence à un point situé sur le territoire français, sa location multiple et de courte durée à partir de ce point situé en France, et même la mise à la disposition du client par une société de gestion française.

En la circonstance, la notion d'établissement semble devoir être appréciée non seulement au sens juridique du terme mais également en tenant compte des circonstances de fait propres à la matière sur laquelle on est éventuellement interrogé.

Sur ce point des locations des moyens de transport et sous réserve de ce qu'a dit, à juste titre, Monsieur GUIEU, à propos des intentions dites de la 10ème directive, il ne semble pas que l'on ait rencontré des problèmes trop difficiles à résoudre et qui méritent de retenir l'attention de l'auditoire.

Ensuite, voici un deuxième cas d'exception: les prestations de services se rattachant à un immeuble se situant en France.

A cet égard, l'approche a été une approche de réalisme, une nouvelle fois, c'est-à-dire que l'on a considéré que les opérations taxables du chef des immeubles sont, non seulement, bien entendu, les travaux immobiliers et les prestations réalisées en vue de la construction de l'immeuble, mais ce que l'orateur appellerait toute la périphérie technique et commerciale, c'est-à-dire aussi bien les opérations techniques préalables à la construction que les commissions on honoraires de gestion par les promoteurs pendant la période de construction, ou les opérations des intermédiaires qui s'entremettent pour l'achat, la souscription ou la vente des immeubles et, bien entendu, les prestations des experts relatives aux travaux de construction.

C'est donc l'idée que toute ce qui se rattache à un immeuble est imposé dans les mêmes conditions que l'imposition afférente à cet immeuble; il est clair, en effet, que s'il n'en était pas ainsi, on aboutirait à des situations absurdes suivant lesquelles une partie des prestations serait taxée dans un pays et l'autre dans un autre: ce serait peu conforme à l'esprit même de simplification qu'a voulu la directive.

C'est un peu autour des mêmes notions qu'ont été traités les problèmes de transport et les prestations accessoires, c'est-à-dire qu'on ne limite pas la notion: on entend non seulement appréhender le transport lui-même mais également les operations qui l'entourent, c'est-à-dire le chargement et le déchargement, la manutention de la marchandise, ou son déchargement, son dosage, son pesage, enfin toutes les opérations qui peuvent être adjointes, y compris les locations de matériel pour le chargement et le déchargement, les gardiennages, les transbordements, les opérations d'assistance aux passagers.

La quatrième dérogation a trait aux opérations culturelles, artistiques, sportives, scientifiques, éducatives, récréatives et les prestations accessoires. Pour celles-ci, l'orateur estime qu'essentiellement la difficulté rencontrée est relative à la formation du personnel étranger, étant donné que dans un certain nombre de cas, les formations de personnel étranger sont liées à des opérations d'exportation: on exporte un matériel déterminé, et on envoie dans les pays producteurs de ce matériel le personnel destiné à utiliser cet appareil et à recevoir la formation ad hoc.

Il est tout à fait conforme, selon lui, et à la volonté de la Communauté et à la situation de fait qu'en la circonstance, cette formation de personnel étranger soit assimilée à une opération relevant d'une activité de conseil en formation et également fasse l'objet d'un traitement identique à celui des exportations.

Les prestations culturelles et autres pour l'essentiel sont le plus souvent exécutées par un assujetti établi dans le pays où la prestation est exercée. Cela est vrai dans un certain nombre de cas, mais cela peut poser des problèmes, non pas de principes, mais des problèmes d'administration, car il est clair que si quelqu'un vient rapidement effectuer une prestation de caractère culturel ou artistique même, il vient, il s'en va, il peut y avoir quelque difficulté pour l'appréhender. Déjà du côté des impôts directs, le même problème a été fréquemment rencontré. Mr. LEBRUN souligne à cet égard, simplement comme une incidente, que les problèmes qui se posent ne sont spécifiques ni à l'harmonisation, ni à la taxe sur la valeur ajoutée; ce sont purement et simplement des problèmes que l'on rencontre dès lors que des opérations sont susceptibles de s'effectuer à travers des frontières, sans perdre de vue que pour un certain nombre d'entre elles, il n'y a même pas de support matériel.

C'est la raison pour laquelle on doit dire que dans l'approche faite par les délégations sur ce sujet, chaque fois qu'il y avait la possibilité, en quelque sorte, d'appréhender ou de saisir physiquement une prestation de services, on a demandé qu'il soit fait retour au principe de l'utilisation; c'est le résultat auquel on aboutit dans la pratique.

Une deuxième catégorie de problèmes: ceux relatifs aux cessions et concessions de caractère intellectuel, aux droits d'auteur, aux prestations de publicité, aux prestations de conseillers. En cette circonstance, un certain nombre de difficultés ont surgi auxquelles on a apporté les premières réponses. On applique en France la directive depuis un an. Au passage, l'orateur félicite la délégation belge de la promptitude avec laquelle elle a mis en vigueur ce texte difficile et déclare battre sa coulpe devant le fait qu'il ait fallu un an de délai pour obtenir le même résultat en France. Il est persuadé que ses amis belges ont, dans un certain nombre de cas, des réponses beaucoup plus pertinentes aux problèmes qui se sont posés, en France.

Il y a eu quelques difficultés concernant les prestations de publicité. Il faut savoir où s'arrête en quelque sorte la notion de prestation de publicité et il est apparu, en la circonstance, que la fourniture des éléments nécessaires à la réalisation de l'opération de publicité devait être assimilée à celle-ci, mais que, en revanche, la distribution d'articles publicitaires, etc. . . , ne représente pas la même notion. Ce n'est pas très facile à délimiter; c'est un domaine dans lequel on sera appelé à plusieurs titres à se concerter davantage.

Pour les autres types de conseils, on a placé dans cette notion de conseils, aussi bien les conseils en brevet d'invention que les conseils en informatique, en recrutement, en organisation, en matière d'études de marchés, en ingénierie. Il n'est pas certain, en définitive, que chacun d'eux ait spécifiquement toujours le titre de conseil mais il est évident que l'on se trouve bien dans un domaine où il y a fourniture par le prestataire de services d'un conseil où le bon sens l'entend, même si, dans un certain nombre de cas, il peut y avoir des arguties sur le sujet.

On a également été affronté avec le problème des fournitures d'information. La notion de fourniture d'information pose quelques difficultés, et voici comment on les a résolues, sans pour autant prétendre détenir la sagesse universelle. On a considéré que relevait du traitement de données, de la fourniture d'information, la prestation qui consistait en l'utilisation d'un ordinateur pour émettre des billets ou donner des informations touristiques, ou pour les terminaux des compagnies aériennes et des agences de voyage, la fourniture d'informations radiodiffusées on télévisées de programme culturel, la transmission d'émissions télévisées par satellite: c'est à peu près les problèmes sur lesquels on a été conduit à s'interroger.

Enfin, il y a quelques opérations relatives aux intermédiaires, de commissions étrangères pour le compte d'inventeurs français, par exemple, et en la circonstance, il est apparu que l'opération effectuée par le commissionnaire était imposable en France dès lors que le bénéficiare était un assujetti établi dans ce pays.

L'orateur déclare avoir fait ce panorama technique des problèmes qu'il a rencontrés en France parce qu'il croit que cela répond au souci de ce colloque et peut servir de base pour les échanges d'informations pratiques permettant de développer progressivement les applications communautaires du texte de la directive.

D'autres problèmes de caractère pratique se posent également: le premier, c'est la notion de siège de l'activité de l'établissement stable: l'orientation utilisée par l'Administration française en a été fournie déjà: à côté évidemment des concepts juridiques qui le définissent, il lui paraît que le réalisme fiscal impose que soit appréhendé comme tel tout centre d'activité où l'assujetti effectue de manière régulière des opérations.

Une deuxième notion qui peut causer des difficultés est la notion de bénéficiaire dans le cadre de l'article 9, 2c de la 6ème directive: il faut entendre par là le client direct du prestataire, sinon on risque d'entrer dans un mécanisme de sous-traitance.

Egalement le problème de la définition de l'assujetti est un cas d'application pratique entre les Etats mais qui, d'après l'orateur, devrait intéresser moins les membres de l'assemblée.

Enfin, on peut avoir des problèmes relatifs à la définition même de l'exécution d'une prestation, mais il n'y a rien de nouveau dans la directive par rapport à ce qui existait antérieurement.

## LUXEMBOURG:

### MAITRE PRUSSSEN

L'orateur déclare que n'étant pas un représentant de l'Administration fiscale luxembourgeoise, il a moins d'expérience sur la question d'autant plus que le texte légal luxembourgeois date seulement du 12 février 1979 et n'entre en vigueur que le 1er janvier 1980. L'expérience que l'Administration luxembourgeoise a pu avoir avec ce texte est donc relativement limitée. Il y a également beaucoup moins de règlementation qu'il y en a à l'heure actuelle en Belgique.

Le texte luxembourgeois contient de nombreuses délégations de pouvoirs au gouvernement en vue de prendre des mesures d'exécution.

En principe, le lieu de la prestation est le lieu du siège d'activité ou de l'établissement stable ou, à défaut, le domicile, car il se pourrait en effet qu'une personne accomplisse des prestations de services alors qu'elle n'a pas de véritable siège d'activité.

La notion d'établissement stable doit être interprétée selon la législation applicable en matière d'impôts directs, la loi sur la T.V.A. ne contenant pas de définition. Il est donc fait application de la loi d'adaptation fiscale, la définition de service tombant sous ce critère doit être recherchée par rapport aux services qui sont expressément énumérés dans la directive.

Pour ce qui est de la dérogation relative aux travaux immobiliers, l'orateur estime qu'il n'est pas toujours facile d'appliquer le critère sur lequel tout le monde s'accorde: il peut arriver en effet qu'un immeuble situé dans un pays déterminé donne lieu à des travaux exécutés dans un autre pays pour le compte d'un preneur localisé dans un troisième pays, et qu'en fin de compte, l'immeuble n'est pas acheté. Voici un exemple vécu: des consultants anglais ayant un bureau à Paris ou à Bruxelles, ont été amenés à donner un avis au sujet d'un immeuble situé à Francfort, pour le compte d'une firme japonaise établie à Londres. Si l'on imagine que l'immeuble n'est pas acheté, la T.V.A. sera due à Francfort.

Deuxième dérogation: le lieu où la partie essentielle du travail est matériellement exécutée d'après la législation luxembourgeoise.

Des difficultés pourront se présenter, car qu'entend-on exactement par la partie essentielle du travail. Ce peut être le cas notamment de l'expertise, celle-ci pouvant parfaitement se situer dans des pays différents: l'expert se rendra sur les lieux, puis rentrera dans son pays pour étudier le cas et rédiger son rapport: quel sera alors le lieu de la taxation? Le pays où le contrat aura été passé? Celui où est situé le bien qu'il aura examiné? Celui où il se sera entretenu avec son client? Ou enfin le pays dans lequel il aura le plus longuement réfléchi à l'affaire?

Ce deuxième critère concerne donc, outre les expertises sur biens meubles dont il vient d'être question, les activités culturelles, artistiques, scientifiques, sportives, d'enseignement, de divertissements, etc.. L'orateur estime que la formation de personnel doit également rentrer dans cette catégorie. Il s'agit aussi d'une activité accessoire au transport, les travaux sur meubles corporels.

Le troisième critère est celui de l'utilisation du bien. Ici le problème du transport se pose d'une façon un peu différente au Grand Duché de Luxembourg parce que le texte dit ceci: "le lieu des prestations de services ayant pour objet la location de biens meubles corporels que le prestataire, en vue de leur utilisation dans le pays de destination, a exportés de l'intérieur du pays vers un autre Etat membre". Le pays extérieur de la Communauté n'est pas pris en considération dans cette dérogation, et le texte poursuit: "ou importé d'un autre Etat membre vers l'intérieur du pays et l'endroit où lesdits biens sont utilisés". Le texte ajoute: "cette dérogation n'est pas applicable à la location des moyens de transport." On constate finalement que l'on a utilisé une seule hypothèse: mais il y a de multiples hypothèses qui économiquement seront identiques et où le principe général sera applicable, c'est-à-dire où la location du bien sera imposable au siège d'activité du prestataire.

En ce qui concerne le lieu du domicile du preneur, l'orateur se réfère à l'énumération de services qui en a été faite précédemment.

Il précise que si une telle activité, parmi celles citées à l'article 9-2, litt.e de la directive est effectuée en relation avec un immeuble, c'est la situation de l'immeuble qui prime.

Quel est le cas du preneur résidant en dehors de la communauté, en ce qui concerne les mêmes services, qui y dispose d'un siège d'activité ou d'un établissement ou simplement d'un domicile?

On distingue, comme dans les exposés précédents, les preneurs assujettis qui sont résidents de la C.E.E. et les preneurs assujettis ou non, résidant en dehors de la C.E.E. Pour les travaux intellectuels visés à l'article 9-2 litt.e de la directive, le lieu de la prestation est réputé se situer au domicile ou au lieu d'activité du preneur.

## Débats

*Remarque préliminaire:* tous les orateurs parlent en leur nom personnel sans aucun préjugé quant à la solution qu'ils pourraient être amenés à prendre, ou leur administration, dans un cas particulier.

*Question* (M. Richou, France)

L'art. 15, 13 de la 6ème directive exonère: "les prestations de services, y compris les transports et les opérations accessoires, mais à l'exception des prestations de services exonérées conformément à l'art. 13, lorsqu'elles sont directement liées au transit, à l'exportation de biens ou aux importations de biens bénéficiant des dispositions prévues à l'art. 14, par. 1 sous b) etc. et à l'art. 16, par. 1.

En France, cette disposition a été reprise sous l'art. 262, §1 du Code général des impôts, qui exonère de la T.V.A. les exportations de biens meubles corporels ainsi que les prestations de services qui leur sont directement liées.

L'Administration a précisé dans ses instructions que ces exonérations s'appliquaient notamment à la location des moyens de transport, des contenants, et des matériels pour la protection des marchandises exportées; aux prestations de formation dispensées aux membres du personnel d'une entreprise étrangère, dans la mesure où ces prestations sont liées à la vente de matériel exporté.

Les autres états de la communauté interprètent-ils de la même façon les dispositions de l'art. 15, 13 de la 6ème directive?

*Réponse*

*1) Location des moyens de transport*

Mr. GUIEU: Tous les Etats membres appliquent le taux zéro. C'est considéré comme une exportation. Il n'y a apparamment pas de difficultés de ce côté là, mais interprétation uniforme de la directive.

*2) Formation de personnel d'une entreprise étrangère liée à la vente de matériel exporté*

Mr. GUIEU: Il y a une divergence d'approche selon les administrations. L'Administration française place ces prestations de service sous la catégorie 9, §2, e; tandis que l'administration belge la classe pour partie dans le 9, §2, c et les taxe avec la possibilité de demander le remboursement par le biais de la 8ème directive (délais et formalités à accomplir, mais le résultat économique est le même).

En ce qui concerne les autres pays, la question n'a pas pu être prospectée.

M. CAPPELLEMAN: Fait preciser par M. Lebrun que dans l'hypothèse visée la prestation de formation a lieu en France et non au lieu du preneur, mais est exonérée pour cause d'exportation.

Pour la situation belge, la prestation de formation est fournie en Belgique aux membres du personnel d'une entreprise qui a acheté en Belgique du matériel qui doit être exporté; dans ce cas, pour nous, la prestation se situe en Belgique et il est parfaitement concevable que cette prestation soit exonérée pour des raisons d'exportation, mais nous n'appliquons en tout cas pas le critère de l'art. 9, §2,e de la 6ème directive.

M. LEBRUN: En effet l'Administration française a analysé cette opération comme une opération de conseil en formation, partie de cette idée que lorsqu'on apprenait à des gens à se servir d'un matériel déterminé, c'était une formation de ce personnel sur le matériel en cause et les conséquences que l'on en tire sont conformes d'une certaine manière à la directive. La seule chose, c'est qu'à partir du moment où elles sont liées également à une opération d'exportation, il nous a paru que pour des raisons pratiques évidentes il était préférable d'avoir une situation d'exportation "classique", sans avoir le sentiment de tirer sur la ficelle, dans la mesure où le résultat

est dans les deux cas une opération qui ne doit pas laisser de taxes à la charge des entreprises auxquelles appartiennent les personnels en cause.
Les analyses auxquelles se sont livrées la France et la Belgique ont finalement les mêmes conséquences et atteignent toutes les deux les objectifs fixés par la Commission; qu'il n'y ait ni double imposition, ni double exonération.

*Question* (M. Richou, France)

Les règles de territorialité relatives aux locations de moyens de transport sont elles les mêmes dans tous les Etats de la Communauté?

*Réponse*

M. GUIEU: Après étude des législations des Etats membres, en ce qui concerne les locations de moyens de transport, il ne semble pas y avoir de divergences: c'est toujours le lieu du prestataire.
Cependant trois pays, la France, la Belgique et l'Allemagne, ont fait usage de la faculté prévue à l'art. 9, §3, c'est-à-dire que s'il y a utilisation faite hors de la C.E.E., il y a quand même détaxation; ce n'est donc plus le lieu du prestataire de services; par contre, s'il y a un véhicule qui vient de l'extérieur mais qui est utilisé à l'intérieur de leurs pays, il y a taxation, bien que le prestataire soit situé hors communauté.
En résumé donc, tous les Etats membres appliquent la règle du prestataire de services avec utilisation de la faculté, pour la Belgique, la France et l'Allemagne.

M. PRUSSEN: Au Grand Duché, il n'y a pas encore de dispositions dérogatoires, mais il y a une habilitation prévue dans la loi. Par voie de règlement cette faculté peut être appliquée.

*Question* (M. van Roye, Belgique)

Quel est le lieu de la prestation de services pour la location de wagons citernes? En ce qui concerne la prestation de services ayant pour objet la location d'un moyen de transport, le lieu de la prestation est réputé se situer à l'endroit où le moyen de transport est utilisé lorsqu'il est donné en location par un loueur qui est établi dans le pays et ce dans la mesure où ce moyen de transport est utilisé hors de la Communauté, ou bien par un loueur établi hors de la C.E.E.

*Réponse*

M. CAPPELLEMAN: La règle principale est le lieu du prestataire, mais avec une double exception selon la législation belge; c'est le lieu d'utilisation lorsque le moyen de transport est donné en location en vue d'être utilisé hors du Marché Commun, c'est alors à concurrence de l'utilisation en dehors du Marché Commun que le lieu du service est situé en dehors du Marché Commun: ou, deuxième exception, quand il s'agit d'un moyen de transport donné en location par un loueur établi hors de la C.E.E.
Ces exceptions sont ainsi limitées car à l'art. 9 de la 6ème directive, on ne parle même pas de moyens de transports et en tant que tels, c'est la règle principale du lieu du prestataire qui s'applique avec la faculté laissée à l'art. 9/3 aux Etats membres de situer le lieu du service dans l'Etat d'utilisation lorsque le lieu du service se situe selon la règle principale en dehors du Marché Commun et qu'on peut établir qu'il y a eu utilisation dans le Marché Commun ou, inversément, lorsque selon la règle principale, le lieu du service se situe dans le Marché Commun et que l'utilisation effective a lieu en dehors. Le Code belge fait usage de l'art. 9/3, mais ne peut aller au-delà.

*Même Question concernant la location de palettes (support plat servant à transporter des marchandises)*

*Réponse*

M. CAPPELLEMAN: Ceci rentre dans les locations de biens meubles corporels autres qu'un moyen de transport.
Que les palettes soient ou non des moyens de transport peut déjà donner lieu à discussion. Si elles en sont, voir réponse supra; si elles n'en sont pas, c'est à nouveau le lieu du prestataire qui est le lieu du service, sauf lorsque le prestataire exporte le bien d'un pays du Marché Commun dans un autre pays du Marché Commun où il doit être utilisé, ou sauf lorsque le bien est donné en location par un loueur qui est établi hors C.E.E.: où dans les deux cas le lieu du service est le lieu d'utilisation.
Dans les cas de locations de palettes ou de wagons si la T.V.A. est due en Belgique d'après les règles énoncées, il peut y avoir exonération, pour des raison d'exportation s'il s'agit de matériel utilisé en trafic international.

*Question* (Mme. Villalong, France)

Une société établie en Suisse a effectué pour le compte d'une société française, bureau d'Etudes Immobilières, des opérations de prospection immobilière. Quel est le sort fiscal de ces opérations de prospection à l'égard de l'art. 259 du C.G.I. selon que ces opérations aboutissent à un marché de travaux immobiliers ou n'aboutissent pas.

*Réponse*

M. LEBRUN: En principe, c'est une opération concernant les immeubles et donc est taxée en France. Si l'opération n'aboutit, j'aurais tendance à penser que dès lors que c'étaient des opérations dont la réalisation éventuelle devait s'effectuer en France, le bon sens implique que ce soit en France que l'imposition soit établie et supportée.

*Intervention d'un participant* (M. Leroy)

La réponse de M. Lebrun me semble contradictoire avec celle qu'a donnée M. Cappelleman tout à l'heure. Pour M. Cappelleman, quand on fait de la publicité pour la vente d'immeubles, on applique la règle relative aux opérations de publicité, et on applique le lieu de l'établissement du preneur. En revanche, quand il s'agit d'une opération immobilière, dit M. Lebrun, même si ça n'est pas dénoué, c'est une prestation de service relative à un immeuble, donc on applique le lieu de situation de l'immeuble.
Ce sont donc là, pour l'intervenant, deux règles dérogatoires qui sont appliquées distributivement par les diffé-

rentes administrations, ce qui n'est guère satisfaisant. De plus, quelle est la dérogation qui prime l'autre? Celle relative aux immeubles ou celle relative à la nature des services?

M. LEBRUN: La question relative à la publicité reçoit sa réponse dans la directive elle-même, peu importe qu'elle soit relative à des immeubles ou non. Pour la question relative aux opérations de prospection, sa réponse a été un peu rapide tout à l'heure: il lui apparaissait qu'elles se situaient à l'intérieur du champ des opérations immobilières.
Il y ajoute que si l'on veut poursuivre l'analyse à partir du moment où l'opération ne s'est pas réalisée, l'on peut considérer qu'il s'est agit en réalité d'opérations de recherche et qu'à ce titre et au titre de l'art. 9, §2,e, le lieu d'imposition est le même.

M. CAPPELLEMAN: Est sur la même longueur d'ondes que M. Lebrun. Pour les prestations de publicité, en Belgique, on applique le critère propre aux prestations de publicité et on ne suit pas le critère relatif aux immeubles.
Quant aux opérations de prospection d'un marché immobilier, si l'affaire aboutit, c'est une prestation se rapportant à un immeuble, et c'est le lieu de l'immeuble qui est pris en considération. Si l'affaire n'aboutit pas, ce dont il n'a pas l'expérience depuis le 1/1/78, on ne considère pas qu'il s'agit d'une affaire qui se rapporte à un immeuble mais on a affaire à une étude de marché, et c'est le lieu du prestataire, mais avec le critère du pays du preneur le cas échéant (art. 9, §2,e).

*L'intervenant:* Ne critique pas la solution mais estime invraisemblable que l'on retienne le critère de l'aboutissement ou non de l'opération pour savoir comment la taxer. C'est oublier que le bureau d'études techniques doit être payé avant, on doit envoyer des factures, des acomptes, sur lesquelles il doit demander une T.V.A., mais laquelle? Et une fois la T.V.A. demandée, si on ne réalise pas l'opération de bureau d'études, est ce qu'on va lui restituer la T.V.A.? Non, parce qu'il l'a mentionnée sur les factures, et dans cette affaire on paiera deux fois la T.V.A.

M. GUIEU: Ne peut que lire les textes communautaires et confirme les interprétations des délégations belge et française.
Pour lui, il est clair que lorsque dans la directive, il y a une qualification d'une prestation de services qui a été citée, c'est ce lieu qui prévaut. Ainsi pour la publicité, c'est toujours le 9, §2,e, ainsi que pour les assurances et les opérations financières. Si l'on prend un crédit pour son immeuble, c'est le 9, §2,e qui joue. Par contre, pour les autres prestations relatives à l'immeuble, il y a une finalité, il faut que l'opération se concrétise.
Si elle ne se concrétise pas, c'est la nature de l'opération qui réapparaît, et c'est le lieu de l'opération qui réapparaît. Il y a peut-être des régularisations à effectuer, mais on ne peut agir différemment, c'est le législateur qui a voulu cela.

*Question* (Mme. Villalong, France)

Une société française transmet à sa maison mère, établie hors C.E.E., certaines données comptables de base. La maison mère tire de ces données comptables certains ratios ou certains documents de gestion. Ces documents ne ressortent pas de façon caractéristique de la profession d'expert-comptable (la maison mère n'exerce pas cette profession), il serait à priori excessif de parler de traitements de données. Où la prestation est-elle taxable?
Dans l'hypothèse la maison mère facture à sa filiale le coût de cette "assistance" administrative, de ce travail de pure gestion. Dans quel sens, large ou restreint, entend on le traitement des données?
Dans un groupe dependant d'une société mère située hors de la communauté, la société mère dispose des moyens, informatiques et autres, qui lui permettent de fournir des services de gestion à ses filiales, en exploitant les données économiques et comptables que les filiales lui transmettent, services qui leur sont facturés.

*Réponse*

M. LEBRUN: Pense que ces opérations doivent se placer sous l'art. 9, §2,e/fournitures d'informations et traitement de données. Donc imposabilité en France en la circonstance, dans le chef du preneur. Au point de vue communautaire, il y aurait pu avoir en plus la garantie du 9, §3 (utilisation du service), mais elle n'est pas utilisée en France.

M. CAPPELLEMAN: Suppose que la société mère et la société filiale ont une personnalité juridique distincte. Car sinon il n'y a pas de T.V.A., mais simple échange entre divisions sans personnalité juridique distincte et donc de prestations de services facturés. Il marque son accord avec M. Lebrun.

*Question* (M. Gossiaux, Belgique)

Une succursale belge d'une société de droit américain vend à un société française du même groupe des marchandises au même prix que cette société française les revend à ses clients en France; pour couvrir les frais encourus par la société française et pour lui assurer une marge bénéficiaire, la succursale belge accorde à la société française un pourcentage minimum de commission. Le contrôleur français prétend qu'il y a lieu d'appliquer sur la note de commission la T.V.A. française, et que par la suite la succursale belge pourra au moyen d'un représentant responsable en France récupérer cette T.V.A. Cette T.V.A. française est-elle due ou non?
La succursale belge lui paie donc une commission qui permet de couvrir les frais de la société française et de lui donner un léger bénéfice.

*Réponse*

M. LEBRUN: Dans une opération de cette nature, il constate d'abord que il y a une opération par laquelle quelqu'un est devenu propriétaire de marchandises donc il n'y a pas de situation de commission.
Deuxièmement, une analyse sur le plan français interne, en ne franchissant pas de frontières, et en analysant les rapports entre deux sociétés, il considérerait qu'il y a une réduction de prix. Mais en tenant compte du fait qu'il y a un franchissement de frontières, il y a une recette complémentaire en quelque sorte, qui est attribuée à la société française.

Cette recette est une recette imposable, en quelque sorte à titre de complément de rémunération, et elle est imposable en la circonstance en France. Ici il ne s'agit pas d'une prestation de nature intellectuelle.

Il semble donc qu'il y a, quelle que soit la dénomination qui lui est donnée, une recette "complémentaire" de l'entreprise française. Celle-ci reçoit un prix de son client qui est celui auquel elle vend le bien, elle reçoit de l'entreprise belge une rémunération pour la vente de ce produit.

M. CAPPELLEMAN: Réagit de la même façon que M. Lebrun, mais ajoute une hypothèse: Si la société belge agit comme courtier de la société française, en principe le lieu du service de la société belge en tant que courtier serait la Belgique; mais la T.V.A. ne serait pas due en Belgique si le courtier intervient dans la réalisation d'une opération qui a lieu à l'étranger, par exemple d'Amérique en France. La T.V.A. n'est pas due en Belgique sur le courtage, quand elle se rapporte à une exportation ou à une opération se déroulant à l'étranger.

*Question* (M. Thielemans, Belgique)

Pourquoi, dans la 6ème directive, n'a-t-on pas retenu comme critère principal le lieu du preneur (critère utilisé en Belgique avant 1978)?

*Réponse*

M. CAPPELLEMAN: Le lieu du preneur est le bon critère car automatiquement on replace la perception dans le pays du preneur qui a normalement droit à la déduction: il y a récupération de T.V.A. qui est portée en compte par le prestataire établi dans un pays étranger. Mais ce critère ne peut non plus être appliqué de façon générale, notamment en ce qui concerne les services qui sont effectués pour le compte de personnes privées ou pour le compte de personnes qui n'ont pas droit à déduction (ex: les prestations de coiffeurs). Il faut donc, quand on accepte le critère du preneur, prévoir une série d'exceptions. Une autre exception est celle qui concerne les immeubles. On en a parlé.

*Question*

Quelles sont les prestations de services qui se rapportent à un immeuble?

*Réponse*

M. CAPPELLEMAN: On a reproché, peut-être avec raison, que le système développé supra était de nature à créer des complications chez les assujettis, étant donné qu'au moment du paiement de l'acompte, il fallait savoir si la T.V.A. était due ou non, ou dans quel pays cette T.V.A. était due.

M. Cappelleman en profite pour insister sur un point: si on dit que la T.V.A. n'est pas due en Belgique parce que le lieu du service n'est pas en Belgique, on ne peut en inférer que la T.V.A. n'est pas due du tout. Or pour les prestations qui sont visées à l'art. 9, §2,e, si la T.V.A. n'est pas due en Belgique, c'est qu'elle est due dans un autre pays du Marché Commun.

Pour revenir à la question, si une étude est faite pour savoir si tel immeuble peut être exploité comme magasin à grande surface ou non, normalement on est tenté de dire que le lieu du service est celui où se trouve l'immeuble, mais d'autres pourraient considérer qu'il s'agit d'une étude de marché aussi longtemps qu'on n'a pas la conclusion. On tourne donc un peu en rond. Et on peut se demander si le critère de la situation de l'immeuble ne doit pas être réservé aux seuls cas où il est tout à fait sur qu'une prestation se rapporte à un immeuble, par exemple les prestations matérielles de construction, de démolition, d'intervention dans la vente de tel immeuble, etc.

La Belgique n'a pas encore du se prononcer et n'a pas encore de solution à cette question pour le moment.

M. LEBRUN: L'analyse de Mr. Cappelleman est tout a fait judicieuse. Il est sur que quand nous sommes dans une opération de cette nature il y a des difficultés d'application pratique.

Si, par exemple, une entreprise anglaise demande à une entreprise Suisse de rechercher en France un terrain sur lequel elle pourrait effectuer une opération de promotion immobilière, d'après les schémas communautaires, cette opération est imposable en France; mais si elle ne se concrétise pas, c'est à priori une opération imposable en Angleterre.

Garantir que derrière l'application de ces principes, il y a une réalité fiscale totale, serait présumer des forces des administrations. C'est un phénomène classique de prestations ternaires.

Les Etats membres ont, en matière de territorialité des prestations de service, presque toujours un possibilité de solution pour les opérations dans lesquelles il y a des relations binaires, c.à d., la Belgique et la France, la France et l'Allemagne, etc.

A partir du moment où intervient un troisième pôle dans l'opération, aucune administration, dans quel que système de taxes indirectes que ce soit, n'est en état de garantir l'application des principes qu'elle peut avoir posé en matière d'imposition.

C'est peut être quand même l'avantage du système de l'imposition dans le pays du lieu de l'immeuble à savoir que s'il y a réalisation, à ce moment là il y aura un intérêt fiscal pour un des opérateurs, à éventuellement dégrever de taxe ce qui aura concourru à la réalisation de l'opération en cours; encore faut-il que cette opération soit soumise à la taxe?

Dans des opérations de cette nature, M. Lebrun est d'un scepticisme absolu et défie la Commission et toute administration de pouvoir proposer une solution qui, si elle n'est pas respectée, puisse être véritablement contrôlée. La faiblesse des hommes et des textes sont incommensurables.

*Question* (M. Gossiaux)

Une société de droit français fait de la publicité en France, la T.V.A. française lui est facturée. La société refacture cette publicité à une société belge ayant une personnalité juridique distincte de la sienne. Le contrôleur français prétend qu'il y a lieu d'appliquer sur cette deuxième facture une T.V.A. française. Ceci paraît à l'intervenant en contradiction avec l'art. 21, §3, 7°, c.

*Réponse*

M. CAPPELLEMAN: Tel est aussi son avis. Si une société française porte des frais de publicité en compte à une société belge, et que tout cela se passe en nom propre de la société française, c'est une prestation de publicité pour laquelle le lieu du service est le lieu du preneur lorsque le preneur est établi dans un Etat membre autre que celui du prestataire.
Pour des services qui sont donnés en cascade, il faut voir chaque relation et non voir la solution finale.
Entre la société française et la société belge, ce n'est pas la T.V.A. française qui est due, mais la T.V.A. belge.

M. LEBRUN: D'accord avec M. Cappelleman.

*Question*

Comment le prestataire sera-t'il assuré que le preneur établi à l'étranger est assujetti, lorsque l'assujettissement est un facteur déterminant de la localisation de service? Sera-t'il responsable si la déclaration du preneur s'avère fausse?

*Réponse*

M. GUIEU: Suppose qu'il s'agit des prestations de services visées à l'art. 9, §2,e (taxation au lieu du preneur)? Quelle est la preuve qu'il faut apporter pour montrer qu'on est un assujetti communautaire?
Par tous moyens de preuve, y compris par une attestation de l'administration fiscale nationale du pays du preneur envers le prestataire.
D'après l'art. 21, §1,b; dans ce contexte là, les Etats membres peuvent prévoir que le prestataire est solidairement tenu responsable d'acquitter la taxe s'il y a eu fraude. C'est une question de contrôle, d'intendance administrative plus que de principes.

*Un intervenant* (Me. de Longueville): On ne peut quand même pas imaginer que chaque fois que quelqu'un va faire un achat dans un autre pays, il se promène avec en poche une attestation à jour de son administration locale. Est-il d'ailleurs prévu? Une carte d'identité d'assujetti pour dans les différents pays? Pas à sa connaissance. Or les contrôles se font quatre ans plus tard. Que se passe t'il s'il y a eu un abus de l'intéressé qui a produit de faux papiers? Déjà sur le plan national le prestataire n'a aucun moyen de contrôle, mais sur le plan international encore moins!
Y a-t'il quelque chose de spécifiquement prévu pour éviter cette situation?

M. GUIEU: C'est exact. Il n'y a pas encore de carte d'identité fiscale et j'espère qu'il n'y en aura pas de sitôt. Mais il y a système d'attestation prévu par la 8ème directive pour le remboursement de la taxe à des assujettis étrangers. Ce moyen pourrait être utilisé déjà. Le prestataire qui va prester quelque chose à un preneur étranger doit quand même savoir à qui il va faire sa prestation car il a une responsabilité non seulement vis-à-vis de lui même pour en recevoir le paiement, mais également vis-à-vis de l'administration puisqu'il peut être solidairement responsable. C'est donc à lui de s'entourer de certaines garanties de preuve. Il pense que ce sont des situations marginales, mais qui peuvent exister. Laisse aux administrations nationales le soin d'indiquer ce qu' elles demandent sur base de ces textes communautaires.

*Question* (Me. de Longueville)

En Belgique, le problème se pose pour l'instant pour des centaines de millions, avec notamment des assujettis, entrepreneurs de travaux qui sont rayés sans que personne ne la sache. Cela bouleverse toute la technique de perception de l'impôt sous la responsabilité du payeur, lequel est obligé pour avoir un minimum de sécurité, même s'il connait très bien son entrepreneur, de téléphoner à son contrôleur, qui lui répond qu'il n'en sait rien, ou écrire et recevoir une réponse trois mois plus tard. Et quant aux listes, elle ne sont pas à jour, c'est d'ailleurs une impossibilité technique. Mais en attendant vous avez reçu des fournitures et vous payez la T.V.A. irrégulièrement sans le savoir.
Comment pense-t-on résoudre ce problème sur le plan international, car la qualité d'assujetti entraine des conséquences très importantes sur le plan de la taxation, déplace les responsabilités. Comment peut on avoir ses apaisements au moment même où on traite, pour savoir si le preneur est vraiement assujetti dans son pays.

C'est un grave écueil du système mis sur pied par la 6ème directive que de faire dépendre de la qualité d'assujetti un régime fiscale particulier.

*Réponse*

M. CAPPELLEMAN: Dans le cadre du lieu de prestation des services, l'art. 22 de la directive contient une possibilité de faculté pour les Etats membres de prendre toutes les mesures destinées à éviter la fraude.
L'Administration belge a donc tiré la couverture à soi en disant qu'en matière de prestations de services, dès qu'une des parties en cause est établie en Belgique, selon une présomption légale la T.V.A. est due jusqu'à preuve du contraire.
C'est donc au prestataire de service qui n'a pas imposé sa prestation de service de démontrer qu'il avait une raison pour ne pas imposer. Ainsi, du côté belge nous n'avons pas trop de problèmes.

M. LEBRUN: Apporte une nuance; dans la pratique, la situation en cause doit être appréciée au moment où les faits se sont produits c.à d. qu'il faut tenir compte du caractère de certitude que pouvait avoir la situation invoquée pour le redevable en cause au moment où les faits se sont produits.
D'autre part, ceci peut être corroboré par les contacts qu'on peut avoir entre administrations. Si l'administration étrangère fait savoir que la personne en cause était régulièrement inscrite et n'a été radiée qu'à partir d'une certaine date, la bonne foi peut être admise. Ce sont des situations de fait dans lesquelles jouent par définition toutes les imprécisions et toutes les incertitudes éventuelles d'appréciation d'une bonne foi. Si un avocat tient à ce que cette bonne foi profite à la personne poursuivie, l'administration de son côté doit s'entourer de toutes les garanties et de prendre tous les éléments de contrôle qu'elle peut avoir pour en apprécier le degré.

C'est la seule réponse possible face à une situation de fait.

*Question*

Est-ce qu'il ne serait pas possible d'envisager un formulaire unifié qui serait tamponné par le représentant de l'administration néerlandaise, ou belge, qui serait adressée au prestataire français ou allemande et qui apporterait la preuve. C'est tout le problème du document probant.
Ne pourrait-il pas y avoir un formulaire européen qui dit tel preneur est assujetti?

*Réponse*

M. GUIEU: Nous avons prévu un tel formulaire dans le cadre de la 8ème directive. Ce formulaire est communautaire dans les différentes langues de la communauté, pour un échange facile entre les administrations de langues différentes. Cette attestation pourra être utilisée le cas échéant. Mais il ne faut pas les multiplier pour chaque opération sinon on risque d'encombrer et les administrations de base pour viser celles-ci, et les administrations d'arrivée avec des masses de papier énormes. Il faut donc avoir une tolérance et des mesures à date avec la connaissance des assujettis qu'ont les services locaux. La mise en place va se faire.

*Question*

Est-ce que l'apport en société d'un brevet est une opération taxable?

*Réponse*

M. GUIEU: Il faut voir deux opérations dans cette affaire. Un brevet est considére comme une prestation de service quand il y a une contrepartie. Quand c'est un apport en capital, cela rentre dans le patrimoine social de la société à qui on apporte un brevet. Il ne pense pas qu'à ce moment là il y ait taxation.

M. CAPPELLEMAN: Il faut savoir qui fait l'apport. Est-ce quelqu'un qui le fait de manière occasionnelle parce qu'il a inventé quelque chose, ou est-ce quelqu'un qui fait cela dans le cadre de son activité professionnelle?
Si c'est une société qui dans le cadre de son activité normale peut exploiter un brevet et qui fait apport de ce brevet soit en propriété, soit en concession, elle fait une prestation de services qui est taxée comme toute autre prestation de service.

# SUJETS II ET III: Assujettis étrangers et leur droit de récupérer la T.V.A.

## Exposé

## BELGIQUE: Régime applicable aux assujettis établis à l'étranger

par J. Autenne*

Sommaire



### I. NOTION D'ASSUJETTI

En vertu de l'article 4 du Code de la TVA, ci-après dénommé "CTVA", est un assujetti toute personne dont l'activité consiste à effectuer d'une manière habituelle et indépendante, à titre principal ou à titre d'appoint, avec ou sans esprit de lucre, des livraisons de biens ou des prestations de services visées par ce code.

Il résulte de cette définition très large que la qualité d'assujetti belge n'est nullement conditionnée par la nationalité ou le domicile d'une personne.

Par ailleurs, il a été précisé dans les travaux préparatoires lors de l'examen du projet de loi créant le Code de la TVA que, pour déterminer si une personne réalise des opérations de manière habituelle, il y avait lieu de prendre en considération non seulement son activité exercée en Belgique, mais également son activité exercée à l'étranger.

Il en résulte qu'une société commerciale établie à l'étranger deviendra assujetti belge pour une seule opération qu'elle réaliserait en Belgique (livraison de biens ou prestation de services) lorsque son activité exercée à l'étranger lui donnerait la qualité d'assujetti belge.

Si cette activité est exercée en Belgique, le régime applicable aux assujettis étrangers est fondamentalement différent selon que ces personnes ont ou non en Belgique un établissement stable.

Nous examinerons donc successivement le régime applicable aux assujettis étrangers selon cette distinction et ce, à la lumière des précisions données par une circulaire de la TVA, de l'enregistrement et des domaines no. 30 de 1975, qui remplace la circulaire no. 105 de 1970.

### II. ASSUJETTIS ETRANGERS QUI ONT EN BELGIQUE UN ETABLISSEMENT STABLE

#### A. Notion d'établissement stable

La circulaire No. 30, du 5 décembre 1975, point 8, précise que pour l'application de la TVA, un assujetti établi à l'étranger est considéré comme ayant en Belgique un établissement stable, lorsque les deux conditions suivantes sont réunies:

1) L'assujetti a dans le pays un siège de direction, une succursale, une fabrique, une usine, un atelier, une agence, un magasin, un bureau, un laboratoire, un comptoir d'achat ou de vente, un dépôt ou toute autre installation fixe;
2) Cet établissement est géré par une personne apte à engager l'assujetti envers les fournisseurs ou les clients.

#### B. Régime applicable

1. Principe

L'assujetti étranger qui a en Belgique un établissement stable est traité comme un assujetti établi dans le pays.

Il peut exercer les mêmes droits, tels les droits à déduction et au remboursement de la TVA en amont et est soumis aux mêmes obligations, telles notamment celles:


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- de déposer une déclaration de commencement d'activité lors de son installation en Belgique et de déposer une déclaration lors d'un changement ou d'une cessation éventuelle d'activité exercée en Belgique.
  (Lorsque l'activité est complètement abandonnée, l'immatriculation de l'assujetti est radiée. Si l'activité se poursuit sans établissement stable, les règles décrites au III ci-après sont applicables);
- de délivrer, sauf exceptions, des factures ou documents en tenant lieu conformément aux dispositions de l'arrêté royal No. 1 et de tenir une comptabilité prévue par cet arrêté, comptabilité qui peut être simplifiée lorsque le chiffre d'affaires de l'établissement ne dépasse pas 15 millions de francs belges;
- de remettre, chaque mois ou chaque trimestre, selon le cas, une déclaration à la TVA (la déclaration peut être trimestrielle lorsque le chiffre d'affaires de l'établissement ne dépasse pas 15 millions de francs belges) et d'acquitter, dans les délais prévus, la TVA ou les acomptes de TVA pour les assujettis soumis à la déclaration trimestrielle dont ils sont redevables;
- de remettre, chaque année, un listing des opérations réalisées avec des clients assujettis, etc.

En ce qui concerne la facturation, il y a lieu de remarquer que celle-ci doit comporter le numéro d'immatriculation à la TVA de l'assujetti étranger et l'adresse de l'établissement stable établi en Belgique.

L'administration admet, toutefois, que les factures soient établies à l'étranger et expédiées de l'étranger, pour autant, bien entendu, que les doubles de ces documents soient conservés en Belgique à l'appui de la comptabilité.

### 2. Immatriculation de l'assujetti étranger

L'assujetti étranger doit se faire immatriculer à la TVA et dépend du contrôle du ressort duquel est situé l'établissement.

Lorsque l'assujetti possède plusieurs établissements, l'office compétent sera celui de l'établissement principal où d'ailleurs devra être tenue centralisée la comptabilité des divers établissements.

### 3. Sort des opérations réalisées sans l'intervention de l'établissement stable

En principe, les opérations que l'assujetti étranger réalise sans l'intervention de son établissement stable en Belgique ne doivent pas être reprises dans la comptabilité tenue en Belgique ni dans les déclarations à la TVA.

Toutefois, si, parmi ces opérations, se trouvaient des livraisons de biens ou des prestations de services qui sont réalisées en Belgique, qu'elles soient ou non soumises à la taxe, et à l'égard desquelles, pour un assujetti étranger sans établissement stable, la désignation d'un représentant responsable est requise, ces livraisons de biens ou ces prestations de services doivent être reprises dans la comptabilité de l'établissement stable et sont soumises aux mêmes règles que les opérations réalisées par l'établissement stable en ce qui concerne la débition de la TVA.

## III. ASSUJETTIS ETRANGERS QUI N'ONT PAS D'ETABLISSEMENT STABLE EN BELGIQUE

### A. Principe

Nous avons vu que lorsque des personnes établies à l'étranger réalisent des opérations en Belgique, même isolées ou exceptionnelles, ces personnes acquièrent la qualité d'assujettis belges si, en raison de leur activité exercée à l'étranger, elles répondent aux conditions de l'article 4 du CTVA.

Lorsque ces entreprises ne réalisent pas ces opérations par le canal d'un établissement stable, elles doivent, avant de réaliser des opérations en Belgique, faire désigner un représentant fiscal responsable.

Nous verrons toutefois que ces personnes sont, dans de nombreux cas, dispensées de cette formalité.

### B. Régime normal: désignation d'un représentant responsable

La réalisation des opérations en Belgique doit se faire par le canal d'un représentant fiscal responsable.

#### 1. Nature des opérations réalisées en Belgique qui rendent nécessaire la désignation d'un représentant responsable

En principe, seule la réalisation d'opérations qui répondent à la définition de livraison de biens au sens des articles 9 et suivant du CTVA (vente de marchandises, etc.) ou de prestation de services au sens de l'article 18 du CTVA (exécution de travaux, cession, concession de droits incorporels, location de meubles, transport, etc.) nécessite la désignation d'un représentant fiscal responsable.

Il importe peu d'ailleurs que ces livraisons de biens ou prestations de services soient imposées à la TVA ou exonérées en vertu des articles 39 à 43 du CTVA (exportation, transit, etc.).

Il faut cependant remarquer qu'en cas d'importation, lorsque la personne établie à l'étranger déclare la marchandise en consommation en se portant destinataire, il y a tout lieu de croire qu'elle revendra la marchandise en Belgique et réalisera donc une livraison de biens imposable.

C'est la raison pour laquelle elle est tenue de désigner un représentant responsable avant l'importation.

Par contre, aucun représentant fiscal ne devrait être désigné si le destinataire et un co-contractant ou lorsque la marchandise n'est pas déclarée en consommation mais bien en transit, en entrepôt ou en franchise temporaire.

#### 2. Agréation du représentant responsable

*a. Conditions à remplir par le représentant responsable*

En vertu de l'article 2 de l'arrêté royal no. 31, le représentant fiscal responsable doit être non seulement domicilié ou établi en Belgique, mais en outre être capable de contracter et présenter une solvabilité suffisante pour assumer les obligations prévues par le code ou en exécution de celui-ci et avoir accepter la représentation.

Il y al lieu de noter que l'agréation peut notamment être accordée à une société avec laquelle l'assujetti établit un courant d'affaires et n'est pas limitée aux organismes de crédit, agences en douane, fiduciaires, etc.

*b. Procédure d'agréation*

L'agréation requiert:

— qu'une demande d'agréation, sur un formulaire préétabli, soit introduite par l'assujetti établi à l'étranger ou par le représentant qu'il compte désigner agissant en son nom et pour son compte, au Bureau Central de la TVA pour assujettis étrangers: rue Van Orley, no. 15 à 1000 Bruxelles (tél. 02/218.44.40). (Le représentant responsable relèvera de ce bureau de TVA);
— que la demande soit accompagnée par une déclaration de commencement d'activité prescrite par l'article 50, paragraphe 1 du CTVA et par l'article 1 de l'arrêté royal no. 10, et pour les personnes morales par une copie de l'acte de constitution de la société ou de l'association avec, le cas échéant, copie des actes modificatifs;
— que le représentant responsables accepte expressément sur un formulaire préétabli la représentation qui lui est confiée.

*c. Etendue de l'engagement pris par le représentant responsable*

(i) *Principe*

En vertu de l'article 55 du CTVA, le représentant responsable est substitué à l'assujetti étranger non seulement pour tous les droits accordés à celui-ci (droit à déduction ou à remboursement de la TVA), mais également pour toutes les obligations imposées à celui-ci (facturation, dépôt de déclarations, paiement de la TVA).

Il est solidairement tenu, avec son commettant, au paiement de la taxe des intérêts et des acomptes dont les opérations en Belgique entraînent la débition.

Il résulte de ce texte général que la responsabilité du représentant peut être très étendue.

Aussi, est-il intéressant de voir quand et comment cette responsabilité pourrait, le cas échéant, être limitée?

Ce problème fera l'objet des points (ii) et (iii) ci-après.

(ii) *Limitation de l'engagement à des opérations déterminées*

La responsabilité du représentant peut, à sa demande, être limitée à des opérations déterminées ou fixées jusqu'à concurrence d'un montant à déterminer d'un commun accord avec l'Administration.

Cette demande de limitation de l'engagement peut être introduite soit lors de la demande d'agréation, soit plus tard, mais alors uniquement pour l'avenir ultérieur.

Il y a lieu de noter que l'assujetti étranger ne peut faire agréer qu'un seul représentant responsable en Belgique.

Il en résulte que l'assujetti étranger ne pourra réaliser en Belgique d'autres opérations pour lesquelles son représentant n'est pas engagé qu'à la condition qu'il soit dispensé pour ces opérations de désigner pareil représentant.

Dans la négative, il y aurait lieu de demander la levée de la limitation de la responsabilité du représentant ou de lui substituer une autre personne.

En tout état de cause, en cas de limitation de responsabilité du représentant, celui-ci ne sera substitué à l'assujetti étranger que pour les droits et obligations qui concernent les opérations couvertes par son engagement.

D'autre part, le bureau central de TVA pour assujettis étrangers peut, dans des cas exceptionnels, limiter la responsabilité de l'engagement financier du représentant à un certain montant qui ne peut être inférieur à 100.000 FB et qui doit couvrir en moyenne le montant de taxe due ou qui sera due pendant trois mois par l'assujetti étranger.

(iii) *Limitation de l'engagement dans le temps*

En principe, le représentant reste responsable jusqu'à la date de cessation d'activité en Belgique de l'assujetti étranger ou jusqu'à l'agréation d'un nouveau représentant responsable.

Il en résulte que le représentant ne peut, en principe, démissionner que s'il notifie par écrit, à l'Administration, soit la cessation de l'activité de l'assujetti étranger, soit l'introduction par l'assujetti étranger de l'agréation d'un nouveau représentant responsable.

Toutefois, l'Administration, consciente du fait qu'une personne ne pouvait être liée indéfiniment pour les opérations accomplies par une personne établie à l'etranger qui continue à avoir une activité en Belgique sans accepter de pourvoir au remplacement de son représentant qui le demande, accepte de prendre en considération la renonciation de celui-ci à sa mission s'il établit avoir fait tout le nécessaire pour assurer son remplacement.

L'assujetti étranger, même après son remplacement ou la cessation d'activité de son commettant étranger, reste tenu, pendant le délai de recouvrement prévu par l'article 81 du CTVA, de la TVA, des intérêts et des acomptes se rapportant aux opérations effectuées sous sa responsabilité.

L'Administration a toutefois admis que le représentant était délié de toute responsabilité des irrégularités:

— lorsque, dans les six mois de la date de retrait de son agréation, le représentant a demandé qu'un contrôle approfondi des opérations traitées par lui soit effectué;
— lorsque ces irrégularités, qui seraient découvertes ultérieurement, ne résultent pas du fait du représentant ou d'une collution entre lui et son commettant étranger.

### 3. Obligations et droits du représentant responsable

*a. Principe*

Le représentant responsable remplit en lieu et place de l'assujetti étranger toutes les formalités imposées par le

CTVA pour les opérations que ce dernier effectue dans le pays.
On consultera pour la liste des principales obligations, B (1) ci-avant.

*b. Dispositions particulières applicables en matière de facturation*

(i) *Mode de facturation*

(1) Règle générale:

- L'assujetti étranger, pour les livraisons de biens ou les prestations de services qu'il a réalisées en Belgique, envoie à son représentant responsable la facture à adresser au cocontractant en ayant soin de ne pas indiquer, sur cette facture, le montant de la TVA due.
- Le représentant responsable établit, en double exemplaire, le document où figurent outre la mention de son identité, de son adresse et d'une référence en sa qualité de représentant, la date de délivrance du document, le nom et l'adresse du commettant, le numéro d'immatriculation à la TVA qui a été attribué à ce dernier, le numéro d'inscription du document au facturier de sortie qu'il tient au nom et pour le compte du représenté, le montant de la TVA due et les autres mentions exigées par l'article 2 de l'arrêté royal no. 1.
- Le représentant responsable adresse l'original du document visé à l'alinéa précédent au cocontractant de l'assujetti étranger, après y avoir annexé la facture reçue de l'étranger. Le double de ce document est conservé par lui.
(Article 4, paragraphe 2 de l'arrêté royal no. 31).

(2) Exception:

L'Administration admet que la procédure visée au point 1 ci-avant ne soit pas suivie et soit remplacée par la manière de procéder décrite ci-après:

- L'assujetti étranger adresse à son représentant la facture destinée à son cocontractant sans indiquer le montant de la TVA due ainsi que deux copies de la facture originale ainsi établie.
- Le représentant mentionne sur les deux copies de facture son identité, son adresse et sa qualité de représentant responsable, la date de délivrance, le numéro d'immatriculation à la TVA de l'assujetti étranger, le numéro d'inscription de la facture au facturier de sortie qu'il tient au nom et pour le compte de l'assujetti étranger, le montant de la TVA due ainsi que les mentions prescrites par l'article 2 de l'arrêté royal no. 1 qui ne figuraient pas sur la facture originale.
- Le représentant responsable adresse l'une des copies de facture ainsi complétée au cocontractant de l'assujetti étranger après y avoir annexé la facture originale; il conserve l'autre copie.

(3) Comptabilisation de la facture par le cocontractant de l'assujetti étranger:

Le cocontractant, s'il peut enregister en comptabilité la facture originale, ne peut toutefois exercer son droit à déduction que sur base du document visé au point 1 ci-avant ou d'une copie de la facture visée au point 2 ci-avant.

(ii) *Délai de facturation et de paiement*

En vertu de l'article 1 de l'arrêté royal no. 1, la facture doit être délivrée au cocontractant au plus tard le cinquième jour du mois qui suit celui au cours duquel le bien est livré, le service est achevé où la taxe est due.

L'Administration a admis que le représentant responsable peut, lorsqu'il n'est pas en mesure de délivrer le document dans le délai prescrit, le délivrer encore valablement jusqu'à la fin du mois au lieu du cinquième jour ouvrable de ce mois.

Il va de soi que, dans ce cas, la TVA due peut être encore valablement reprise dans la déclaration suivant celle de la période au cours de laquelle elle aurait dû être reprise.
En compensation, le cocontractant assujetti se voit reporter d'une mois dans l'exercice de son droit à déduction.

*c. Dispositions particulières en matière de déduction*

Pour pouvoir opérer la déduction, les assujettis doivent normalement détenir l'original de la facture qui leur a été adressé par le cocontractant ou le document d'importation qui a été levé à la frontière.

Pour tenir compte du fait que très souvent l'original de la facture doit être comptabilisé au lieu d'établissement de l'assujetti étranger, l'Administration admet que la déduction soit opérée au vu de photocopie de facture pour autant que les conditions suivantes soient remplies:

- L'assujetti étranger doit justifier à l'Administration l'obligation légale que lui impose le pays où il est établi, de détenir les factures originales au siège de l'entreprise.
- Les photocopies doivent porter la mention, apposée par la société étrangère et certifiée par elle, qu'elles sont conformes à l'original; cette mention doit être paraphée par le représentant responsable qui en prend la responsabilité.
- L'assujetti étranger doit s'engeger par écrit à mettre temporairement les factures originales à la disposition du représentant responsable, à la demande de l'Administration pour les besoins du contrôle (Code, art. 61).

## 4. Création d'un établissement stable

Lorsqu'un assujetti étranger avait désigné un représentant responsable en Belgique et créé ensuite un établissement stable, il conserve son numéro d'immatriculation mais change d'office de contrôle pour dépendre de celui dans le ressort duquel est situé l'établissement stable.

Dans ce cas, une déclaration de changement d'activité doit être établie.

### C. Régime général d'exception: dispense de l'agréation d'un représentant responsable

1. Cas dans lequel l'assujetti étranger est dispensé de désigner un représentant responsable

L'assujetti étranger est dispensé de faire agréer un représentant responsable:

- pour les prestations de services de caractère intellectuel qu'il effectue dans le pays (travaux d'étude et de contrôle, études de marché, entreprises de publicité, cession ou concession de droits intellectuels, tels que brevets, marques de fabrique et de commerce, droits d'auteur);
- pour les prestations de services de caractère matériel qu'il effectue occasionnellement en Belgique;
- pour les opérations, de caractère occasionnel, comportant la revente, dans le pays, de biens qu'il y a achetés ou importés;
- pour les livraisons de biens et les prestations de services effectuées dans le pays mais exemptées de la taxe en vertu des articles 39 à 42 du Code (par exemple, les transports internationaux de marchandises).

Le point de savoir si l'assujetti étranger effectue habituellement ou occasionnellement des opérations en Belgique est évidement délicat.

L'Administration a précisé à ce sujet qu'il y avait lieu de considérer que les opérations réalisées en Belgique avaient un caractère répété lorsqu'elles auraient entraîné l'assujettissement de la personne qui les réalise, si celui-ci était établi en Belgique.

Il faut toutefois remarquer que bien qu'une opération puisse juridiquement être considérée comme isolée, elle nécessitait la désignation d'un représentant responsable lorsqu'elle impliquait la réalisation de grands travaux de génie civil (construction de routes, ponts, usines, etc.).

Il faut enfin noter que l'assujetti peut avoir intérêt à désigner un représentant responsable et renoncer à la dispense. Tel sera notamment le cas de l'assujetti qui veut déduire immédiatement la taxe dans sa déclaration, qui désire bénéficier du régime de report de paiement de la TVA à l'importation (Article 4, paragraphe 3 de l'arrêté royal no. 7) ou qui désire réaliser des importations temporaires de matériel destinées à l'exécution de travaux de toute nature (voir à ce sujet circulaire no. 9 de 1978 de l'Administration de la TVA, de l'enregistrement et des domaines).

2. Mode de perception de la taxe

*a. L'assujetti étranger accomplit des opérations autres que des prestations de transports internationaux de personnes*

(i) *L'assujetti a exercé le droit à remboursement de TVA belge en amont*

En vertu de l'article 5 de l'arrêté royal no. 31, la TVA due sur les opérations réalisées en Belgique est acquittée par l'apposition et l'annulation de timbres fiscaux.

A cette fin, l'assujetti étranger établit une facture, en double exemplaire, portant les mentions prescrites par l'article 2 de l'arrêté royal no. 1. Il appose et annule la partie supérieure des timbres sur la facture qu'il délivre à son cocontractant et la partie inférieure de ces timbres sur le double de la facture qu'il conserve.

L'annulation de chaque partie des timbres est faite en caractères très apparents, soit par une mention manuscrite, au moyen d'une encre indélébile, comprenant la date de l'annulation et la signature de l'assujetti étranger, soit par l'emploi d'une griffe reproduisant à l'encre grasse, outre la date, le nom patronymique, la dénomination ou la raison sociale de l'assujetti étranger. La date doit seule être reproduite entièrement sur la partie du timbre annulée; la signature doit être complète, mais elle peut déborder (v. arrêté royal no. 31, art. 5, al. 3).

L'apposition et l'annulation des timbres fiscaux peuvent être opérées, non seulement par l'assujetti établi à l'étranger, mais également par un correspondant ou un mandataire agissant pour son compte en Belgique, et notamment par son cocontractant établi dans le pays.

(ii) *L'assujetti étranger n'a pas à exercer de droit à remboursement de TVA belge en amont*

Dans cette hypothèse qui se rencontrera surtout lorsque l'assujetti étranger effectue de simples prestations de services de nature intellectuelle (cession ou concession de brevets, travaux d'études, etc.), la TVA belge ne droit pas être acquittée par l'assujetti étranger.

En effet, le cocontractant de l'assujetti étranger payera la TVA en lieu et place de son fournisseur étranger. S'il est assujetti, il le fera par inscription au cadre V. a) ou à la case 31 ou 32 selon qu'il dépose une déclaration mensuelle ou trimestrielle.

Lorsque le cocontractant n'est pas assujetti, il acquitte la taxe en apposant ou annulant des timbres fiscaux entiers sur la facture reçue de l'étranger ou à défaut de facture, sur un document qu'il crée à cette fin.

Cette obligation doit être remplie dans les 10 jours consécutifs au 5me jour ouvrable du mois qui suit celui au cours duquel le bien a été livré, le service a été achevé ou la TVA est devenue exigible.

La facture ou le document en tenant lieu doit contenir les mentions prescrites à l'article 2, 2me à 6me alinéas de l'arrêté royal no. 1, ainsi que la date de sa délivrance ou de son établissement et éventuellement le numéro d'ordre sur lequel il est inscrit au facturier d'entrée.

L'annulation se fait comme cela a été décrit ci-avant (voir point (i)), sous la seule réserve que les deux parties du timbre doivent restées adhérentes et que la mention ou la griffe doit être apposée dans le sens de la plus large dimension du timbre (article 6, 2° de l'arrêté royal no. 31).

*b. L'assujetti étranger accomplit des prestations de transports internationaux de personnes*

Le transport rémunéré de personnes autre qu'un transport maritime ou un transport aérien international est soumis à la TVA dans la mesure où le transport est effectué dans le pays.

Les transporteurs de personnes, à défaut d'établissement en Belgique, doivent normalement avoir un représentant responsable dans le pays. (L'existence de ce représentant est justifiée par la production à la douane d'une lettre d'agréation ou d'un certificat en tenant lieu, délivré par le Bureau Central de TVA pour assujettis étrangers.)

L'Administration admet cependant que les transporteurs étranger qui n'ont pas de représentant responsable, puissent être admis dans le pays pour des transports internationaux de personnes, en acquittant à la douane les sommes forfaitaires suivantes, moyennant dépôt d'une quittance no. 258:

- Transport de personnes par service non régulier:
  - véhicule carrossé pour transporter au maximum 6 personnes, outre le chauffeur: 30 F;
  - véhicule carrossé pour transporter plus de 6 personnes et au maximum 10 personnes, outre le chauffeur: 75 F;
  - autocar carrossé pour transporter plus de 10 personnes et au maximum 20 personnes, outre le chauffeur: 150 F;
  - autocar carrossé pour transporter plus de 20 personnes, outre le chauffeur: 300 F;
  - bateau: 300 F.
- Transport de personnes par service régulier (autobus ou bateau): 600 F.

Pour autant que la quittance no. 258 comporte le numéro de la plaque d'immatriculation du moteur et du châssis et soit présentée à la douane, le véhicle peut pénétrer plusieurs fois par jour en Belgique.

### 3. Mode d'exercice d'un droit à remboursement de la TVA en amont

*a. Conditions mises au remboursement*

L'assujetti étranger peut obtenir le remboursement des taxes grevant ses entrées pour autant qu'il fournisse au Bureau Central de TVA pour assujettis étrangers le double, dûment revêtu des timbres, des factures délivrées à son cocontractant conformément à l'article 5 de l'arrêté royal no. 31.

Le remboursement ne peut porter que sur les taxes grevant les biens et les services qu'il justifie avoir utilisés pour l'exécution des opérations ainsi facturées. Une comparaison des factures d'entrée ou des documents d'importation — qui doivent être produits à l'appui de la demande — et des factures de sortie est ainsi nécessaire, ce qui implique une rédaction précise de ces factures, notamment en ce qui concerne la désignation des biens et des services et des quantités achetées et vendues.

Le remboursement des taxes en amont peut également être accordé à l'assujetti établi à l'étranger:

- lorsqu'il prouve que les biens et les services grevés des taxes belges ont été utilisés pour l'exécution d'opérations exemptées de la taxe en vertu des articles 39 à 43 du Code (exportations, transports internationaux de marchandises, ventes à des ambassades, fournitures de biens ou de services à des assujettis titulaires d'une autorisation délivrée en application de l'article 43 du Code, etc.);
- lorsqu'il prouve que les biens ou les services grevés des taxes belges ont été utilisés pour l'exécution d'opérations effectuées par lui à l'étranger et qui auraient été imposées si elles avaient été effectuées en Belgique;
- lorsqu'un transporteur étranger de personnes établit qu'il a acquitté la taxe, à la douane, selon les règles prévues ci-avant.

*b. Procédure de remboursement*

Les demandes en remboursement doivent être accompagnées d'un relevé récapitulatif des factures d'entrée et des documents d'importation ainsi que des factures de sortie constatant les TVA dues.

Dans l'hypothèse où les factures de sortie sont exonérées de TVA en raison d'une exportation, l'assujetti doit également transmettre les documents qui justifient la cause de l'exemption tels par exemple les documents d'exportation.

Les remboursements sont normalement effectués dans les trois mois de l'introduction de la demande. Lorsque la demande de remboursement est justifiée par des opérations exonérées de la taxe parce que afférentes à l'exportation, non soumises à la taxe parce que réalisées à l'étranger ou soumises à la taxe mais sujettes au régime particulier du paiement examiné ci-avant pour un transport de personnes, celle-ci n'est prise en considération que si elle porte sur un montant de TVA qui atteint 65.000 F. ou 25.000 F. selon que le chiffre d'affaires annuel réalisé en Belgique dépasse ou est inférieur à 15 millions. En tout état de cause, la demande peut être retenue en fin d'année civile, pour autant que le montant de TVA à rembourser atteint 300 F.

Le paiement est effectué par virement au compte courant postal ouvert en Belgique ou à l'étranger au nom du créancier ou de son mandataire, ou par transfert à une banque établie en Belgique, à un organisme visé à l'article 1er, alinéa 2, 1°, de l'arrêté royal No. 185 du 9 juillet 1935, sur le contrôle des banques et le régime des émissions de titres et valeurs, à une entreprise visée à l'article 1er, alinéa 2, 3°, du même arrêté, à une association de crédit agréée par la Caisse Nationale de Crédit Professionnel ou à une caisse de crédit agréée par l'Institut National de Crédit Agricole.

Lorsque le paiement doit être fait en mains d'un mandataire, une procuration doit être jointe à la demande de remboursement. Les signatures doivent être légalisées par l'agent diplomatique ou consulaire belge et par le Ministère des Affaires étrangères de Belgique, si l'acte est dressé à l'étranger, sauf en ce qui concerne les actes publics qui ont été établis sur le territoire d'un Etat contractant de la Convention supprimant l'exigence de la légalisation des actes publics étrangers, faite à La Haye le 5 octobre 1961. Dans ce cas, la seule formalité qui puisse être exigée pour attester la véracité de la signature, la qualité en laquelle le signataire de l'acte a agi et, le cas échéant, l'identité du sceau ou timbre dont cet acte est revêtu, est l'apposition de l'apostille définie à l'article 4 de ladite Convention, délivrée par l'autorité compétente de l'Etat d'où émane le document. Pour les actes sous seing privé établis en Belgique, les signatures doivent être certifiées authentiques par un notaire belge. Les procurations établies dans une langue autre que le français, le néerlandais ou l'allemand doivent être accompagnées d'une traduction.

Si le bénéficiaire du remboursement n'est pas titulaire d'un compte courant postal en Belgique ou à l'étranger, ni d'un compte auprès d'un des organismes financiers précités, le paiement a lieu par assignation postale. Les frais d'encaissement de cette assignation sont à la charge du bénéficiaire du remboursement.

Le bureau central renvoie à l'assujetti étranger les documents qui ont justifié sa demande. Ceux-ci doivent être conservés par l'assujetti étranger pendant cinq ans.

### D. Régimes particuliers d'exception

Des régimes particuliers sont prévus par la circulaire No. 2 du 11/1/79 pour les ventes par filières avec l'intervention occasionnelle d'assujettis établis à l'étranger et par la circulaire No. 4 du 14 février 1979 sur les importations de biens avec montage.

## FRANCE: Documentation

*Conséquences de la territorialité des prestations de services: moyens mis à la disposition du prestataire étranger non établi en France, débiteur d'une T.V.A. française, pour lui permettre de s'acquitter de ses obligations*

Les règles législatives et administratives se trouvent dans les documents suivants:
Code Général des Impôts, Article 289A;
Document de base 3A 222 et Instr. Adm. du 15 février 1979.

*Conséquences de la territorialité des prestations de services: récupération par le bénéficiaire étranger d'une T.V.A. afférente à une prestation de service taxable à la T.V.A. française*

Document de base 3A 223 et Instr. Adm. 3A-16-79.

*MINISTERE DU BUDGET*
*Service de la Législation Fiscale*
*Sous-Direction D* — *Paris, le 15 janvier 1980*
*Bureau D2*

*Direction Générale des Impôts*
*Service de l'Administration Générale*
*Sous-Direction III C*
*Bureau III C 2*

*Monsieur le Chef de Service,*

*Vous avez appelé l'attention sur le régime applicable, en matière de taxe sur la valeur ajoutée, aux prestations de caractère immatériel désignées à l'article 259 B du Code général des Impôts, rendues par des prestataires étrangers à des preneurs assujettis en France.*

*Faisant observer que les prestataires étrangers ignorent généralement la réglementation en vigueur dans ce domaine et ne facturent pas la taxe sur la valeur ajoutée, vous demandez que soient précisées, dans ce cas, les modalités de déclaration, de paiement et de déduction de la taxe par les bénéficiaires des prestations.*

*Conformément aux dispositions de l'article 259 B du Code général des Impôts, les prestations figurant à cet article sont imposables en France lorsqu'elles sont effectuées par un prestataire établi hors de France et lorsque le bénéficiaire est établi et assujetti à la taxe sur la valeur ajoutée en France.*

*Par ailleurs, aux termes de l'article 283-2 du Code, la taxe exigible sur ces prestations doit être acquittée par le bénéficiaire. Toutefois, le prestataire est solidairement tenu avec ce dernier au paiement de la taxe.*

*En outre, pour les mêmes prestations, les articles 289-I et 289-A-II du Code font obligation au prestataire d'une part, d'établir la facture et d'autre part, de désigner, à défaut du paiement de la taxe par le preneur, un représentant établi en France qui remplit les formalités incombant au redevable et acquitte la taxe.*

*Lorsque la taxe est acquittée par le bénéficiaire, il est admis que le prestataire étranger ne fasse pas mention de cette taxe sur la facture ou le document en tenant lieu (note de frais, note d'avoir. . .) qu'il adresse à son client français.*

*Celui-ci annote alors cette facture ou ce document de la mention "Prestation désignée à l'article 259 B du Code général des Impôts — Taxe sur la valeur ajoutée due par le bénéficiaire" et du montant de la taxe dont il est redevable.*

*La taxe correspondante est ensuite déduite du cadre III de la même déclaration pour son montant réel (ligne 11) ou forfaitairement (ligne 12).*

*L'imprimé CA12 (ou CA12 E) ne permettant pas d'individualiser les prestations énumérées par l'article 259 B, le bénéficiaire doit indiquer dans le cadre réservé à la correspondance, qui figure au bas de la première page, ou sur une note annexée, la base d'imposition correspondant à ces opérations ainsi que la date d'exigibilité de la taxe sur la valeur ajoutée.*

# Réflections

## BELGIQUE:

**M. CAPPELLEMAN**

*Description du régime auquel sont soumis les assujettis étrangers en ce qui concerne d'une part leur obligation d'acquitter une T.V.A. étrangère, d'autre part le droit de récupérer la T.V.A. qui leur est portée en compte conformément aux prescriptions de la 8ème directive récemment publiée au Journal Officiel*

Lorsqu'il s'agit d'assujettis étrangers (établis à l'étranger) qui font en Belgique certaines opérations, on peut faire une triple distinction.

1) Les assujettis étrangers qui ont en Belgique un établissement stable ou un siège d'exploitation.
Ils sont tenus en Belgique pour les opérations qu'ils y font aux mêmes obligations que les assujettis belges, sans aucune distinction.

2) Les assujettis étrangers qui effectuent en Belgique des opérations soumises à la T.V.A., sans y avoir un siège d'exploitation ou un établissement stable.
Ces assujettis sont en principe tenus d'avoir en Belgique un représentant responsable qui, en fait, remplit au nom et pour le compte de l'assujetti étranger les obligations des assujettis belges en général et qui exerce également les mêmes droits. C'est donc par ce représentant responsable que la T.V.A. due est payé et que la T.V.A. à déduire est récupérée.

3) Mais dans certains cas, l'assujetti étranger est dispensé d'avoir un représentant responsable.
Tel est le cas lorsque l'assujetti étranger effectue en Belgique des opérations qui tombent dans le champ d'application de la T.V.A., mais qui ne sont pas soumises effectivement à la T.V.A., parce qu'il y a exonération pour raisons d'exportation ou parce qu'il s'agit d'opérations tout à fait isolées, ou encore et surtout parce qu'il effectue en Belgique des prestations de services qui sont taxables dans le pays du preneur (art. 9, §2 de la 6ème directive ou l'art. 21, §3, 7° du Code belge).

Dans cette situation où l'assujetti étranger n'a pas de siège d'exploitation ou d'établissement stable en Belgique , la T.V.A., lorsqu'elle est due, doit être payée directement par le preneur. L'assujetti ne la devra éventuellement que par application des règles de solidarité.

Si l'assujetti étranger a exposé en Belgique des dépenses grevées de T.V.A., en relation avec ces prestations de service qui sont imposées directement à charge du preneur, il pourra récupérer cette T.V.A. qui lui a été portée en compte sur ses dépenses sous forme de restitution.

Il en est de même lorsque l'assujetti étranger effectue en Belgique des opérations qui sont exonérées pour des raisons d'exportation.

Tout cela sous la réserve qu'un assujetti belge aurait pu récupérer la T.V.A. dans les mêmes conditions.

Il y a certaines limitations du droit à déduction en Belgique, notamment pour les véhicules, pour le transport de personnes où la déduction ne peut jamais dépasser 50 pour cent de la T.V.A. qui a été payée. En ce qui concerne les biens d'investissement, nous avons une disposition "temporaire" qui existe depuis 1970 et qui maintient une limitation de 5 pour cent, sauf lorsqu'il s'agit d'investissements complémentaires ou créateurs d'emploi.

Tel que ce régime fonctionne en Belgique depuis 1971, les assujettis étrangers ont toujours pu récupérer les T.V.A. qui ont été payées, dans les circonstances décrites ci-dessus. Ce régime de restitution va même au-delà de ce qui est prévu dans la 8ème directive, étant donné que celle-ci oblige les Etats membres à rembourser aux assujettis étrangers la T.V.A. qu'ils ont supportée sur leurs dépenses, uniquement dans les cas où les assujettis étrangers n'effectuent pas dans un autre Etat membre des opérations soumises à des taxes, par exemple quand un industriel français participe à une foire commerciale en Belgique où il ne vend pas et ne fait qu'exposer sa marchandise; mais une T.V.A. lui est portée en compte pour des frais d'électricité, de publicité, etc. . .

La 8ème directive dit encore que la T.V.A. doit être remboursée aux assujettis étrangers qui effectuent dans un autre Etat membre des opérations exonérées de transport (trafic international de marchandises surtout).

Autre cas: lorsqu'un assujetti étranger effectue dans un autre pays membre des prestations de services, pour lesquelles la T.V.A. doit être payée exclusivement par le preneur du services.

D'après le contenu de la 8ème directive les assujettis étrangers qui font en Belgique des dépenses grevées de T.V.A. peuvent depuis 10 ans déjà récupérer cette T.V.A. à condition de prouver qu'il s'agit de dépenses qui ont été faites dans le cadre d'une activité permettant la déduction. Mais à partir du 1er janvier de l'année prochaine en tout cas, les autres Etats membres devraient accorder aux assujettis belge la restitution de la T.V.A. que ces derniers auront payée dans les autres Etats membres pour effectuer les opérations qui viennent d'être décrites.

La législation belge nécessite-t-elle beaucoup d'adaptation au regard de la 8ème directive? En fait, non. Tout au plus certaines formalités seront-elles à adapter, ou certains délais ou le plafond de restitution, car actuellement on ne restitue que sur la base d'une demande trimestrielle et pour autant que le montant de T.V.A. à restituer atteigne au moins 25.000 Fr.Frs.; or, il faudra l'accorder dès qu'on atteint 200 unités de compte Européens ( + ou — 8000 FB).

## FRANCE:

### MONSIEUR LEBRUN

L'orateur partage la conclusion de Monsieur CAPPELLEMAN sur les bienfaits de la 8ème directive, car la mise en oeuvre de cette directive apportera en France une situation qui a été demandée par beaucoup d'assujettis étrangers. Il croit donc qu'elle apportera également dans les relations économiques internationales quelques avantages.

Si l'on s'en tient à la situation antérieure (avant la mise en oeuvre de la 8ème directive) on peut dire qu'en ce qui concerne les modalités dans lesquelles un prestataire redevable de la taxe en France s'acquitte de ses obligations, qu'elles sont essentiellement les suivantes: lorsqu' il s'agit du prestataire, on applique l'article 259a, pour les entreprises établies en France, et l'article 259c, pour les entreprises établies hors de la Communauté. Les modalités sont claires: la nécessité pour ces entreprises de faire accréditer auprès de l'Administration française un représentant qui s'engage à remplir les formalités incombant au redevable et à acquitter la taxe en ses lieu et place.

Ce représentant fiscal doit être une entreprise établie en France et connue à ce titre de l'Administration fiscale. Il doit accomplir exactement toutes les obligations qui incomberaient à une entreprise établie en France et conduisant en France ses activités, c'est-à-dire notamment la tenu de la comptabilité de l'opération.

*Un point particulier:* c'est la facturation. Normalement, la facturation des opérations est établie par le représentant fiscal qui doit mentionner qu'il agit en qualité de représentant de l'entreprise représentée, indiquer son nom et son adresse, mais on a également admis que l'entreprise représentée puise faire la facturation avec l'obligation inverse, c'est-à-dire qu'elle indique qu'elle est représentée en France par telle et telle personne.

Le représentant fiscal bénéficie de l'ensemble des dispositions applicables à tous les redevables établis en France. Il en bénéficie et en supporte aussi les conséquences, c'est-à-dire qu'il peut avoir à réparer les omissions ou les insuffisances qu'il aurait commises pour le compte de l'entreprise étrangère.

En ce qui concerne les prestations de services imposables du chef du preneur, imposables au titre de l'article 259b, on note qu'en la circonstance il y a accomplissement de ces formalités par le bénéficiaire du service et que l'on a établi une solidarité entre le bénéficiaire et le prestataire. Il est admis que lorsque le prestataire est étranger, il ne fasse pas mention de la taxe sur les factures ou les documents en tenant lieu qu'il adresse à son client français, à condition de noter sur cette facture qu'il s'agit d'une prestation visée à l'art. 259b, du Code général des impôts, taxe sur la valeur ajoutée, due par le bénéficiaire. Cette solution est de nature à imposer un minimum d'obligations aux entreprises étrangères puisque dans cette hypothèse, l'entreprise étrangère est simplement solidaire du prestataire établi en France.

Sur les modalités de récupération de la taxe par une entreprise étrangère non établie en France, taxe qui lui a été facturée par un prestataire français, l'orateur déclare que l'Administration française appliquera dans son entièreté, la 8ème directive à compter du 1er janvier 1981.

## LUXEMBOURG:

### MAITRE PRUSSEN

Si un assujetti étranger a un siège d'exploitation ou un établissement stable au Grand-Duché, c'est le même système qu'en Belgique avec quelques petites différences, pour autant qu'on veuille appliquer l'art. 21 de la directive qui prévoit le paiement de la taxe par le débiteur en cas de services visés par l'art. 9/2.

En effet, au Grand-Duché, on a simplement prévu une habilitation dans la loi et aucun règlement n'est intervenu à l'heure actuelle, de façon que le prestataire de services reste le débiteur. L'application de cet article 21 de la directive ne se fera pas sans difficultés.

L'on aura des preneurs qui sont assujettis, mais qui feront eux des opérations exonérées et qui devront déposer des déclarations pour des services qui leur ont été facturés.

Tous les médecins, tous les hôpitaux, tous ceux qui ne déposent pas de déclaration devront le faire dans le futur, sous l'empire de l'art. 21.

C'est peut-être là la raison pour laquelle l'Administration n'a pas encore réglementé et peut-être considère-t-on que le système où le prestataire fait lui-même la déclaration est plus simple.

*Declaration et garanties*

En pratique, le prestataire de services étranger qui fait une opération à Luxembourg, est obligé de la déclarer. Il n'est pas nécessairement obligé d'avoir un représentant fiscal, tel que c'est le cas en Belgique.

Mais s'il est obligé de déclarer, il peut être obligé par l'Administration d'avoir un représentant fiscal. On peut également demander d'autres garanties. En principe la déclaration se fait assez simplement; un seul bureau à Luxembourg est compétent, c'est le bureau no. 10. Le préposé du bureau en question se met en rapport avec le prestataire pour fixer une entrevue et voir quel régime on pourrait appliquer. En effet, le régime varie selon la multiplicité des services et le nombre des clients.

La manière est donc assez souple. On demande aux prestataires de faire une déclaration par voie de lettre. Un dossier fiscal sera ouvert mais sans numéro d'immatriculation.

S'il s'agit d'opérations multiples auprès d'un client unique, on peut convenir que ce sera le preneur, tenu solidairement en vertu de la législation interne, qui fera la déclaration à décharge et paiera également la décharge. Sinon on demandera au prestataire de faire les déclarations mensuelles ou trimestrielles, ou annuelles; cela dépendra du nombre de service prestés.

Mais l'Administration demandera le cas échéant des garanties. Ces garanties peuvent consister en la nomination d'un représentant fiscal ou un cautionnement à la Caisse de consignation ou une garantie bancaire.

En principe, le préposé du service fixera le montant du cautionnement en raison de la créance estimée du Trésor, mais toujours est-il que le prestataire peut demander et peut toujours fournir un représentant fiscal qui assumera alors l'obligation de garantie solidaire et qui assumera certaines obligations, lesquelles toutefois ne vont pas aussi loin qu'en Belgique.

Il faudra détenir le double des factures et toutes les pièces nécessaires pour la déclaration et le contrôle. C'est le prestataire qui établira les factures et non le représentant fiscal. Les taux étant relativement simples et facilement identifiables, il ne se posera pas tellement de problèmes aux prestataires en question.

Le prestataire aura immédiatement eu des rapports très personnels et très directs avec l'Administration, il discutera lui-même avec le préposé responsable de la manière la plus appropriée, compte tenu des services prestés, pour faire la déclaration en question.

Sous la législation actuelle donc, c'est toujours le prestataire qui est obligé en principe de faire la déclaration et ce n'est pas le preneur de la prestation, même dans le cas de différents services, l'art. 21 de la directive le prévoyant.

*Déduction et remboursement*

Alors quid de la procédure de la déduction et du remboursement?

L'assujetti pourra récupérer la taxe par le biais de la déduction de la taxe en amont, s'il fait des opérations imposables dans le pays qui prélève la taxe. Mais c'est lui qui aura dû faire la déclaration de ses propres prestations et demander au preneur de faire la déclaration à décharge.

Le texte de la 8ème directive est très clair en ce qui concerne les remboursements. Il prévoit comment il faut faire la demande de remboursement.

En principe, aucune difficulté n'est à prévoir à condition que la demande soit accompagnée des factures originales et de l'attestation de l'Administration.

Je dois préciser que la 8ème directive ne s'applique pas aux cas où le preneur fait lui-même des opérations imposables dans le pays puisque dans ce cas il pourra lui-même obtenir le remboursement par restitution ou par déduction de la taxe en amont ou par restitution de l'excédent de taxe. Mais il faut dire qu'à l'heure actuelle, la pratique administrative est telle qu'on demande au prestataire de faire lui-même les déclarations parce qu'on estime que s'il ne le fait pas lui-même ou qu'il n'exécute pas lui-même les obligations qui sont à sa charge et qu'il laisse par exemple le preneur déclarer à décharge, il ne remplit pas ses obligations, auquel cas l'excédent de taxe ne lui est pas remboursé.

Cette pratique administrative n'a pas encore été soumise jusqu'à présent au Tribunal. Elle sera adaptée au moment où le Gouvernement décidera effectivement de prendre le règlement qui concernera les services plus spécialement énumérés à l'art. 9/2,e.

Sauf exception, il ne devrait pas se poser de discussion à Luxembourg pour le preneur de services pour obtenir le remboursement d'une façon ou d'une autre.

## Débats

*Question*

La question est relative au cautionnement et au représentant responsable au Luxembourg.

M. Prussen avait dit dans son exposé que l'Administration, d'après un texte récent, peut, avant la réalisation d'une opération imposable par un assujetti qui n'a pas d'établissement stable au Luxembourg, faire agréer un représentant responsable. Il a ajouté que l'Administration pourrait exiger en lieu et place dudit représentant responsable la fourniture d'un cautionnement approprié par un institut financier établi au Grand-Duché de Luxembourg.

L'Administration ferait valoir que le régime en question est instauré pour des raisons pratiques et de facilité, mais elle empêcherait dans certains cas, en raison de l'importance du cautionnement bancaire, certaines entreprises belges à obtenir des crédits pour les besoins de leur trésorie.

*Voici la question:* Est-ce que les membres du groupe connaissent dans leur secteur des difficultés similaires? Dans l'affirmative, la charge financière du système de cautionnement a-t-elle été réellement excessive? N'estime-t-on pas que l'obligation de cautionnement est en contradiction avec le texte même de l'article du règlement qui dispose que le cautionnement est applicable sans préjudice des dispositions des art. 66 et 67, si ce sont des articles qui ont trait au représentant permanent.

*Réponse*

M. PRUSSEN: L'interprétation qui est donnée par l'Administration à ce texte est que, pour des raisons pratiques, il est possible, pour un entrepreneur étranger qui n'a pas de base fixe à Luxembourg, de donner un cautionnement soit en versant une some à la Caisse des consignations, soit — ce qu'il fait généralement — en présentant une caution bancaire en lieu et place d'un représentant parce qu'on estime que, peut-être à tort, il est parfois plus difficile de trouver une personne qui accepte d'assumer toutes les obligations.

C'est une solution de rechange. Le texte doit être interprété de cette façon que l'on peut donc exiger ce cautionnement et que le prestataire peut toujours proposer et faire agréer un représentant responsable en lieu et place du cautionnement. Si ce cautionnement ne peut pas être fourni ou si l'Administration, pour d'autres raisons, l'estime nécessaire, elle peut exiger de tout façon un représentant responsable. Si l'entreprise en question estime que les charges financières sont trop élevées, elle a toujours la possibilité de s'adresser par exemple à son preneur pour demander à celui-ci d'être le représentant responsable.

*Question*

Les Administrations compétentes savent-elles qu'une rémunération est demandée normalement par le représentant responsable professionnel?

*Réponse*

M. CAPPELLEMAN: Je dirais personnellement: non. Mais je suppose qu'il y en a une.

*Question*

Les Administrations compétentes savent-elles si les formalités imposées en fait aux redevables étrangers sont, en frais financiers et en perte de temps, incompatibles avec le fonctionnement normal du commerce international et une transparence aussi grande que possible des frontières spécialement pour les petites et moyennes entreprises et pour les professions libérales?

*Réponse*

M. CAPPELLEMAN: Je voudrais bien insister sur le fait que si notamment en Belgique on exige qu'un assujetti étranger qui effectue des opérations soumises à la taxe ait un représentant responsable, ce n'est pas pour le seul plaisir d'avoir un représentant responsable, c'est surtout en vue d'assurer l'exacte perception de l'impôt, d'avoir des garanties quant à l'application normale de la T.V.A. et d'avoir également des garanties de recouvrement. Nous comprenons fort bien que l'on insiste sur la grande transparence des frontières, mais nous devons assurer un contrôle aussi exact que possible et aussi fermé que possible. Il existe encore un phénomène que l'on appelle fraude en matière de T.V.A. Le système T.V.A. n'est pas hermétique, malheureusement. Et l'on constate tous les jours que le système T.V.A. permet certaines fraudes. C'est pourquoi l'on ne peut pas enlever aux Administrations nationales les moyens de lutter contre la fraude.

Nous n'ignorons pas qu'un représentant responsable, cela demande du temps et des formalités, mais nous estimons que c'est une nécessité. Je voudrais ajouter que le représentant responsable ne doit pas être nécessairement une personne tout-à-fait étrangère à l'opération conclue. Il est admis en Belgique que si une société étrangère fait une opération isolée avec une entreprise belge, c'est ce client qui se porte le représentant responsable, auquel cas des frais supplémentaires sont évités. Le représentant responsable entraîne une charge, sans doute, surtout pour les entreprises qui font régulièrement des opérations en Belgique avec des clients différents.

M. GUIEU: Nous sommes très conscients évidemment qu'il y a de la fraude en matière de T.V.A. et qu'il faut essayer, par tous les moyens, de l'éviter ou du moins de la prévenir.

Mais il faut essayer de trouver aussi des mécanismes qui évitent l'utilisation du représentant fiscal. Et justement, en matière de prestations de services, notamment celles visées à l'art. 9,2°,e, si on avait suivi l'opinion de la Commission, à savoir "taxation auprès du prestataire avec la notion d'exportation du service" on aurait peut-être évité tout un champ d'application du représentant fiscal. Il est regrettable que nos propositions n'ont pas abouti; nous avons eu des contacts avec les professionnels et ils nous indiquent tous qu'un représentant fiscal ou une caution coûtent fort cher aussi bien pour la société que pour l'économie générale de l'entreprise. Il faut donc essayer par tous les moyens de limiter autant que faire se peut, cette utilisation du représentant fiscal.

On est donc obligé de l'utiliser, mais on a déjà essayé dans le cas de la 8ème directive, de supprimer le représentant fiscal et l'on a pu atteindre ce but de tout façon pour tous les assujettis étrangers qui peuvent obtenir un remboursement dans le pays étranger sans l'intervention d'un représentant fiscal. C'est une amélioration sensible par rapport à la situation ancienne. Les efforts ne doivent pas se ralentir, il faut essayer de trouver des mécanismes évitant de telles interventions, tout en évitant bien entendu les fraudes.

M. LEBRUN: Les réponses de mes deux prédécesseurs indiquent qu'il y a une préoccupation de l'Administration et, de l'autre côté une préoccupation plus économique. Cette dualité a été en fait au coeur de nos débats. Je ne pense pas trahir un secret en disant que lorsque nous avons discuté une proposition de la Commission sur la 8ème directive, celle-ci conduisait en France à l'abandon de la notion de représentation fiscale. Mais elle a été accompagnée en réalité de l'adoption de deux directives relatives à l'assistance fiscale des états pour le recouvrement en matière de droit des douanes et en matière de taxe sur la valeur ajoutée. On a donc été conscient qu'il existait des problèmes de d'administration.

D'autre part, la notion de représentant fiscal ne doit pas être totalement condamnée, ne serait-ce que parce que dans un certain nombre de cas elle permet d'assurer une égalité entre les différents pays concernés; j'ajoute aussi qu'il n'est pas en soi condamnable que quelqu'un effectuant des opérations imposables en France, par exemple, soit astreint dans certaines conditions d'avoir une représentation fiscale. Mais la notion de représentation fiscale, on doit s'efforcer de la circonscrire afin de libérer davantage les échanges. Je partage également et entièrement les préoccupations de mon collègue M. Cappelleman au sujet des phénomènes qu'il a mis en avant.

*Question* (M. Autenne)

Lorsque le preneur, tel un établissement hospitalier, qui aurait la qualité d'assujetti au sens de la 6ème directive, reçoit un service pour lequel le critère d'imposition est le lieu d'établissement du preneur, comment la T.V.A. du pays est-elle perçue? Quelles sont les garanties de perception pour le Trésor dans l'hypothèse où ce preneur, n'étant soumis à aucune obligation, ne fait pas l'objet d'un contrôle? Comment la taxe doit-elle être perçue dans ce cas-là?

*Réponse*

M. CAPPELLEMAN: Tout d'abord effectivement, un établissement hospitalier est un assujetti au sens de la 6ème directive, mais un assujetti exonéré parce que les activités sont de caractère social. En Belgique on con-

sidère que tous les établissements hospitaliers sont de nature sociale.
Depuis l'Arrêté royal no. 31 de 1971, dans une situation pareille, la T.V.A. doit être perçue par le preneur du service, par l'apposition de timbres fiscaux entiers, sur la facture reçue et la taxe doit être acquittée dans les dix jours qui suivent la réception de la facture ou l'expiration du délai de la facturation.
Je pense donc que le mode de paiement de la T.V.A. est parfaitement réglé par les textes. Quant à dire qu'il en est de même de ce qui concerne le contrôle du paiement, j'estime que le contrôle est possible.

M. LEBRUN: C'est d'abord un problème d'Administration. Mais je crois, tout-au-moins au travers de la législation française, qu'à partir du moment où nous avons créé une solidarité entre les prestataires et le preneur, le prestataire lui-même a intérêt à ce que son preneur ne se soit pas placé dans une situation fiscale irrégulière. Nous ne pouvons pas écarter l'opinion suivant laquelle les intérêts "solidaires" du prestataire et du preneur consisteraient à tenter d'éviter l'impôt, surtout si, dans l'hypothèse qui a été envisagée, il s'agit d'un établissement qui n'est pas soumis à la taxe et qui n'a donc pas la possibilité de déduire les taxes sur ses achats. Dans l'exemple de la clinique, ou bien celle-ci est soumise à la T.V.A. étant donné les conditions dans lesquelles elle exerce en France son activité, et dans ce cas-là il n'y a pas de problème. Ou bien elle n'est pas soumise à la T.V.A. (hôpital public, centre hospitalier, centre universitaire) ces établissements sont de toute façon tenus d'avoir une comptabilité, ils sont même dans un certain nombre de cas, des établissements publics et, à ce titre, soumis à un contrôle d'un représentant de l'Etat.

M. PRUSSEN: Le problème ne se pose pas seulement pour les hôpitaux, mais pour tous les assujettis qui font les opérations exonérées et qui ne sont pas tous les assujettis qui font partie des pouvoirs publics. Chez ceux-là, il y aura effectivement un problème de contrôle. C'est la raison pour laquelle au Grand-Duché de Luxembourg, on n'a pas encore fait application de cette disposition, on a simplement prévu une habilitation.
Donc le prestataire devra lui-même déclarer par voie de lettre à l'Administration et payer lui-même la taxe.

*Question*

Une société belge possède un établissement stable en France. Elle prend en location des wagons citernes auprès de bailleurs français. Ces wagons citernes sont utilisés en Belgique. Depuis le 1er janvier 1979, en suite de l'adaptation de la législation française à la 6ème directive communautaire, la T.V.A. française est due. Comment récupérer cette T.V.A.?
Il ne serait pas, selon certains avis, possible pour l'établissement français d'imputer la T.V.A. sur celle due en raison de son activité, étant donné que cet établissement français est considéré comme formant un secteur d'activité distinct de celui exercé en Belgique.

*Réponse*

M. LEBRUN: Je crois qu'il y a une réponse à terme et une réponse immédiate. La réponse à terme, c'est la 8ème directive à l'évidence. La réponse immédiate: il est exact que la société en cause ne peut pas déduire la taxe dont elle est redevable en France puisque ce n'est pas au titre de son activité imposable en France que la taxe est demandée en déduction, mais l'Administration a fait prendre une décision ministérielle en la circonstance autorisant le remboursement, et avant même l'intervention de la 8ème directive (décision ministérielle du 29.09.1979 qui a été diffusée d'une part dans le Bulletin officiel, et d'autre part dans un certain nombre de publications).

*Question*

Une société belge agit comme courtier pour le compte d'un client au Canada, sollicitant des ventes pour le compte de la société canadienne auprés de clients en Europe. L'opération est en principe exemptée de T.V.A. en vertu de l'art. 21. Mais la solution est-elle la même, que les ventes de la société canadienne se fassent à l'étranger ou en Belgique?
L'auteur de la question précise également que la société belge touche une commission de la société canadienne, que les marchandises sont vendues et expédiées au client final, mais non prélevées dans un dépôt se trouvant en Belgique par exemple.

*Réponse*

M. CAPPELLEMAN: Dans ce cas, la T.V.A. n'est jamais due en Belgique puisque le courtier intervient toujours dans des opérations qui se situent à l'étranger pour la livraison de biens, livraison qui a lieu au départ des marchandises. Il en est de même quand le client final est en Belgique.
Le raisonnement est toujours le même pour les prestations de courtage où la règle principale, c'est le lieu du prestataire. Mais il y a exonération lorsque le prestataire intervient dans une opération qui est exonérée pour des raisons d'exportation, ce qui n'est pas le cas ici, où lorsqu'il intervient dans des opérations qui s'effectuent à l'étranger, ce qui est bien le cas, puisque la marchandise est toujours expédiée du Canada à destination de tous pays dans le monde, en sorte que la T.V.A. n'est pas due: le lieu du service, c'est en Belgique, mais il y a exonération en vertu de l'art. 41, §2 du Code belge.

*Question* (Me. de Longueville)

Quel recours a le contribuable quand il y a divergence d'interprétation entre deux administrations nationales? Existe-t-il au sein du Marché Commun une commission chargée de régler ces problèmes et le contribuable peut-il introduire auprès de cette Commission le recours que cela comporte?
Cette Commission peut-elle être consultée avant que le problème ne se pose concrètement c'est-à-dire qu'il y ait conflit ouvert entre le contribuable et deux ou plusieurs administrations nationales?

*Réponse*

M. GUIEU: La question peut comporter plusieurs réponses.
D'abord il faut savoir où se situe le problème. Y a-t-il ambiguité de texte qui aboutit à des législations ou à des interprétations différentes de pays à pays, auquel cas le

contribuable ou le représentant ou le syndicat professionnel peut toujours demander à l'Administration de son propre pays de poser ce problème dans le cadre du Comité de T.V.A., pour savoir comment est appliquée dans les autres pays, la disposition ambigüe. Ici nous avons une mécanisme de concertation où l'on examine les orientations que l'on peut dégager pour arriver à une interprétation communautaire, si possible, ou, au moins majoritaire ou grande majoritaire, parce qu'il y a des nuances dans nos orientations.

Mais il peut aussi y avoir un litige au cours duquel le contribuable pense que la disposition nationale ne correspond pas du tout aux directives communautaires. Alors deux possibilités: ou l'intéressé saisit la Commission par une plainte et la Commission doit examiner la situation et répondre à la plainte, le cas échéant ouvrir une procédure d'infraction sur base de l'article 169 du Traité de Rome.

Avant d'arriver à cette application de l'article 169, un dialogue est engagé avec l'Administration concernée, des explications sont demandées, des visites sur place sont parfois effectuées, on cherche des précisions et ce n'est qu'en connaissance de cause définitive que l'on envoie l'affaire devant la Cour de Justice de Luxembourg.

Une autre procédure est possible: le contribuable saisit la juridiction nationale en demandant à la juridiction nationale de poser une question préjudicielle à la Cour de Luxembourg pour connaître l'interprétation de cette Instance sur le texte litigieux et sur la 6ème directive.

Il y a donc beaucoup de possibilités d'approche en fonction du degré de divergences entre la législation nationale et ce que croit l'assujetti par rapport à la législation communautaire, pour arriver à savoir exactement où se situe la difficulté.

Mais avant d'arriver à ces cas de procédure, il y a toute une procédure amiable de contact avec l'Administration nationale. Il nous arrive à nous-mêmes de recevoir des demandes des syndicats professionnels, etc., et je vous dirai que nous sommes d'une prudence assez grande dans ce domaine et que nous renvoyons très souvent aux Administrations nationales pour provoquer une concertation multi-nationale.

Enfin, je voudrais compléter ma réponse en disant qu'à partir du 1er janvier 1981, on appliquera la directive sur l'assistance mutuelle. Ce sera une occasion inespérée d'avoir des échanges entre administrations pour essayer de régler cela d'abord sur le plan bilatéral et ensuite tous les problèmes qui peuvent se poser au sein du Comité de T.V.A.

Mais je ne vois pas de saisine directe des assujettis devant les instances communautaires sauf la plainte auprès de la Commission.

*Question*

Quelle est la solution apportée dans les trois pays sur le problème d'assujettis étrangers n'ayant pas d'établissement stable à l'étranger ni dans le pays, ni d'activité connue à l'étranger, mais bien dans le pays?
Quel est le cas du commerçant ambulant, par exemple, qui pourrait avoir un domicile de complaisance non réel.

*Réponse*

M. CAPPELLEMAN: Cette personne doit au moins avoir quelque part un établissement, un domicile en matière de prestations de services. Il est dit expressément que le prestataire de services a un lieu où il établit son activité etc., ou, à défaut d'un tel siège ou d'un tel établissement stable, le lieu de son domicile ou de sa résidence habituelle.

En Belgique, il n'y a pas mal de familles de tziganes (dont il a été question il n'y a pas encore si longtemps); quand on essaye de chercher quelqu'un dans la famille, on ne le trouve jamais, mais toujours quelqu'un d'autre. Cela pose effectivement des problèmes et c'est d'ailleurs pour cela qu'on parle de prendre certaines mesures, notamment en matière de véhicules d'occasion.
En fait, si un étranger passe la frontière avec une roulotte chargée de marchandises, il est obligé d'avoir un représentant responsable. C'est vraiment un des cas dans lequel le représentant responsable est nécessaire, parce que même s'il ne peut pas passer la frontière sans payer la T.V.A., il faut encore assurer la perception de la T.V.A. pour les ventes qu'il fera dans le pays. C'est précisément un des cas où on ne voit réellement que le représentant responsable comme sauvegarde pour l'observation et le respect des formalités normales en tant qu'assujetti.
En matière de prestations de services, c'est encore beaucoup plus délicat. Je crois que je ne peux pas m'expliquer beaucoup sur le cas de commerçants ambulants en matière de prestations de services. Cela pourrait être un cirque, mais dans ce cas-là précisément la 6ème directive dit expressément que le lieu du service est le lieu où le cirque exerce son activité. Ce sera donc une imposition coup par coup.
Mais si c'est une autre petit commerce ambulant, je crois que dans la plupart des pays on dira qu'en tant que petite entreprise il sera exonéré; en Belgique, ce commerçant sera taxé.

M. LEBRUN: Je me suis interrogé pour savoir comment j'arriverais à répondre à cette question. Je me suis dit si on me lit les lignes de la main, c'est une prestation de services.

Je me suis fait deux réponses. La première c'est que c'est le prestataire qui est taxable et qu'à partir du moment où ce prestataire a, dans l'hypothèse envisagée un domicile fictif et que nous ayons la possibilité de démontrer le caractère fictif de ce domicile, j'aurais tendance à dire que le prestataire a son domicile à l'endroit où il a lu les lignes de la main en question.
La deuxième réponse, Monsieur de Président, parce que dans les choses sérieuses, il faut à certains moments ajouter une boutade, il n'est vraiement pas besoin de lui faire franchir une frontière et je défie toute administration de faire réellement payer la taxe sur la valeur ajoutée aux cartomanciennes ou aux lectrices de la main que l'on peut trouver sur les foires et marchés. Mais ceci est une autre histoire.
En d'autres termes, je crois que la territorialité en la circonstance n'intervient pas. Mais comme il s'agit a priori de petites entreprises, en tout état de cause, elle bénéficieraient des différents régimes applicables aux petites entreprises dans les différents pays communautaires.

# VAT SEMINAR organized by the French - Belgian - Luxembourg Branch of IFA - March 7, 1980

## INTRODUCTION

by Prof. Dr. Paul Sibille

*Several national branches of the International Fiscal Association (I.F.A.) have for several years maintained the excellent custom of bilateral meetings at which reports are presented and discussions take place on topics and questions of particular interest to the participant countries.*

*In this way, as a continuation of the workshop held in Paris in May 1978, the French and Belgian-Luxembourg branches organized a workshop in Brussels on March 7, 1980.*

*The topic for the workshop was the difficulties in applying Article 9 of the Sixth Directive of the European Communities of May 17, 1977, concerning the place where services are considered to be supplied, thereby creating liability to VAT, and the solutions which must be brought to bear (taking into account the Eighth Directive, which has just been adopted by the Council of Ministers of the European Community, concerning arrangements for the refund of value added tax to taxable persons not established in the territory of the country).*

*Experience since January 1, 1978 — the date on which the Sixth Directive of the European Communities came into force, at least in certain of the member states — would seem to indicate that Article 9 of the Directive poses some problems to which the solution under the current legislation and relevant administrative instructions of the countries concerned, to the extent they exist, is far from obvious as it varies from one country to another.*

*The particular problems considered at this workshop were the following:*

*a) to define concretely the services, enumerated in Article 9 of the Directive, which are placed under the jurisdiction of the tax administration in the country where the supplier of services is domiciled;*

*b) what would the supplier of services, who owes VAT in a country where he has no business or establishment, do to meet his obligations* without excessive difficulty *on an administrative or financial plane?*

*c) how can the consumer of services who has borne the charges for these services recover them* without excessive difficulty *when, fulfilling the necessary conditions to obtain this refund, he has not established a business in the country where VAT has been paid by the supplier of services?*

*The workshop was presided over by Mr. Henry LEVY MORELLE, President of the Belgian-Luxembourg branch of I.F.A., assistant professor at the Free University of Brussels. Co-chairman was Mr. Georges EGRET, Secretary-general of the French branch of I.F.A., replacing the President, Mr. Max LAXAN.*

*That this workshop was productive is due, on the scientific side, to Messrs. Jean de LONGUEVILLE and Guy van FRAYENHOVEN, respectively President and member of the Scientific Committee of the Belgian-Luxembourg branch, and, on the organizational side, to M. Jacques AUTENNE, lecturer at the Catholic University of Louvain, Secretary of the Belgian-Luxembourg branch.*

*The Belgian-Luxembourg branch is pleased to be able to publish the results of this workshop, comprising the reports, the essential parts of the lectures and resumés of the debates, with the International Bureau of Fiscal Documentation in Amsterdam.*

*The gathering of this material has been realized thanks to the notes taken and transcribed by Madame Marie-Cécile van GRIEKEN, assistant at the Higher School of Fiscal Sciences, under the direction of Professor P. SIBILLE, Director of the School.*

*This publication will doubtless constitute a valuable guide for lawyers and tax experts and for enterprises which are continually confronted with one of the most complex international problems concerning VAT.*

**INCORPORATION OF THE SIXTH VAT DIRECTIVE INTO DOMESTIC LEGISLATION**

All member countries of the European Communities have now adjusted their VAT legislation in accordance with the Sixth Directive. The changes have become effective at the following dates:

| | |
|---|---|
| *Belgium* | – 1st January, 1978 |
| *Denmark* | – 1st October, 1978 |
| *France* | – 1st January, 1979 |
| *German Federal Republic* | – 1st January, 1980 |
| *Ireland* | – 1st March, 1979 |
| *Italy* | – 1st April, 1979 |
| *Luxembourg* | – 1st January 1980 |
| *Netherlands* | – 1st January, 1979 |
| *United Kingdom* | – 1st January, 1978 |

## SUMMARY *

of *"Localisation of taxable operations"* by Jacques Malherbe, Lecturer at the University of Louvain and advocate at the Brussels Bar.

*Delivery of goods.* Both the Sixth Draft Directive (Article 8.1.b.) and the Belgian VAT Code provide that the delivery of a good occurs at the place where the good in question is physically present at the moment of delivery. The Directive further provides that where a good is transported the delivery is deemed to take place at the point of departure (Article 8.1.a.). The Belgian Code obtains the same results by providing that the delivery is deemed to have taken place at the moment that transportation starts. Where goods are assembled, the delivery is deemed to take place upon completion of the assembly (Article 15, Para. 1, (2)(1°)).

*Rendering of services.* The Sixth VAT Directive situates the place where a service is rendered at the main place where the economic activities of the entrepreneur are performed or at the location of his permanent establishment if the service is rendered by this establishment. In the absence of these criteria the service is deemed to have been rendered at the place where the entrepreneur has his domicile or residence. Thus the Sixth Directive abandons the criterion of place where the service is utilized, which was introduced by the Second Directive and which is also to be found in the former Belgian VAT legislation.

Article 21 (new) of the Belgian VAT Code brings Belgian VAT law in line with the provisions of the Sixth Directive. This also applies to the numerous exceptions to the main rule which the Sixth Directive introduced. These exeptions include:

1. Services connected with real property are deemed to have been rendered where the property is situated (Directive, Article 9.2.a. and Code, Article 21, Para. 3 (1°)). These services include, in addition to construction activities, services rendered by real estate agents acting as intermediaries and experts, services rendered by architects, by surveyors, and by engineers, the renting of parking lots, of furnished lodgings, of warehouses, of camping sites and of other real property as well as of strong boxes and also the management of real property.
2. Transportation is deemed to be carried out where transportation takes place varying with the distance covered (Directive, Article 9.2.b. and Code, Article 21, Para. 3 (3°)).
3. Services which are deemed to have been rendered in the place where the service is actually performed include: cultural activities, activities connected with transportation, activities connected with tangible movable property. The Belgian Code localizes the latter activities in the place where the good is physically present.
4. The renting of movable tangible goods (other than means of transportation) is deemed to take place where they are being used. If the lessor is established in the EEC the good in question must be exported to the Member State where it is being used.
5. The main place where the economic activities of the entrepreneur are performed or his permanent establishment is situated (or, in the absence of these criteria, his domicile or residence) is considered as the place where the following services are performed:
   - sale or licensing of rights, including sales monopolies and the right to exercise a professional activity,
   - advertising,
   - banking and financial operations (excluding the renting of strong boxes and insurance transactions which are exempted),
   - the hiring out of personnel,
   - services of intermediary persons with the exception of those carried out by certain commission agents (Directive, Article 9.2.e.; Code, Article 21, Para. 3 (7°)).

## SUMMARY*

of *"The regime of the value-added tax applicable on the rendering of services after the amendments of the law resulting from the implementation of the Sixth Directive"* by Messrs. R. Gerbes (chartered accountant) and Y. Prussen (attorney at law).

In Luxembourg the Sixth Directive on VAT was implemented by the Law of February 12, 1979 which became effective on January 1, 1980. With respect to services the most important change introduced by this law was a new definition of the place where a service is deemed to be rendered which changed the liability for Luxembourg VAT purposes.

Currently the main rule is that a service is deemed to be rendered in the place where the supplier has his business or permanent establishment from which the service is rendered.

However, there exist numerous exceptions to this rule.

Services connected with real property are deemed to be rendered where the property is situated. This is, for instance, the case with services rendered by architects, the maintenance of a building, services rendered by real estate agents, notaries and other experts in connection with real property, the renting of real property, including hotel rooms, storage rooms, safes and parking space. However, the service must be rendered with respect to a *specific* real property otherwise the main rule applies.

Transportation services are deemed to be rendered where the transport takes place. However, international transport is generally exempt.

In a number of cases a service is deemed to be rendered where it is physically carried out. This is, for instance, the case with cultural, scientific and similar activities, ancillary transport activities and work with respect to movable goods.

The place of utilization determines the place where the service is rendered in case of hiring out of movable tangible property which is exported by the lessor from one Member State with a view to its being used in another Member State. However, in all other cases the main rule applies. Another group of services is generally deemed to be rendered in the place where the *customer* has established his business or has a fixed establishment to which the service is rendered. This group includes the sale and licensing of patent rights and other industrial rights as well as banking services and publicity. The rule applies when the services are performed for customers established outside the Common Market or for *taxable persons* established in the Common Market.

Non-resident entrepreneurs carrying on taxable transactions in Luxembourg must — as under the previous legislation — register the transaction with the VAT office. Generally a return must be filed before the fifteenth day of the second month following the month in which the transaction was effected. If the Luxembourg customer is subject to Luxembourg VAT the non-resident entrepreneur must send him an invoice indicating the amount of VAT before the 25th day of the month in which the transaction was effected. If the non-resident entrepreneur regularly operates in Luxembourg he will be registered by the VAT office and the authorities may demand that he appoint a responsible representative or put up a guarantee.

* This summary has been made by the Editors of the Bulletin who are solely responsible for its contents.

## SUMMARY OF PAPERS ON THE FIRST SUBJECT *

*Mr. Guieu (Common Market)*

The speaker pointed out that the present provision in the Sixth Directive regarding the place where a service is deemed to be rendered is a compromise which the EEC Members were able to approve, but he admitted that it could possibly cause difficulties at the national level.

When in April 1967 the Second Directive was adopted it was believed that the ideal solution had been found: services would be subject to VAT in the place where they were utilized.

However, the scope of this provision was very limited since it applied only to services indicated in Annex B of the Second Directive which was, in addition, not compulsory for the Member States. These States were further permitted to deviate from the above rule, provided that no double taxation would occur.

Another problem which emerged was that the Member States defined the place of utilization in different ways. Criteria used were: (i) the place where the supplier of the service was located, (ii) the place where the receiver of the services was located and (iii) the place of actual utilization. Double, or even triple, taxation or non-taxation would have resulted if the Member States had not introduced a great number of exceptions. However, this resulted in a multitude of complicated rules which deviated from country to country.

In order to remedy this situation the Commission proposed to abandon the criterion of utilization of a service and to concentrate the criterion for determining the place where a service is rendered around the person rendering the service. However, one correction was necessary: where a service would be "exported" from one Member State to another, VAT should be levied by the "importing" State as is the case with export of merchandise. Unfortunately, two more exceptions had to be introduced, i.e. for services relating to real property which are deemed to have been rendered in the place where the property is situated, and for transportation which is deemed to be rendered where the transportation is carried out taking into account the distance covered on the territory of the countries concerned.

In the present text of Article 9 of the Sixth Directive one finds the general rule that a service is deemed to be rendered in the place where the supplier has established his business. This permits the legislature to cover all cases where services are rendered to persons not subject to VAT, using one uniform rule which permits neither non-taxation nor double taxation.

However, the Member states did not stop at the introduction of deviating rules for real property and transportation. Other exceptions to the main rule comprise cultural activities, activities connected with transportation and services rendered with respect to tangible movable goods.

Another exception to the main rule is to be found in Article 9.2.e. of the Sixth Directive where, in case of "export" of certain, sometimes indicated as "intellectual", services to either a taxable person in a Member State or to any person (taxable or not) in a non-Member State, it is the place of business establishment of the receiver of the service which is the criterion for determining the place where the service is rendered. This means that to such services two different criteria apply according to the circumstances, i.e. where the receiver is established and whether he has the status of taxable person or not. Although this exception can be defended on economic grounds, the Common Market experts regret this dualistic approach.

The situation is even more complicated since the Member States are authorized to use the old criterion (of place of utilization where services are rendered to persons established in non-Member States) in those cases where there would otherwise be non-taxation, double taxation or distortion of competition.

What kind of difficulties may arise can be illustrated by the following example. Assume an entrepreneur purchases a tangible movable good (not a means of transportation) in another Member State, which it leases to a customer in that other State. Some countries consider this transaction to be effected in the place where the supplier of the service is established, whereas other countries find that the place where the customer is established is decisive.

In order to clarify this situation the Commission has proposed a Tenth Directive which provides that the service is in such a case rendered in the country where the customer is established by deeming that the supplier of the service has his business in that country.

Another problem which arises after the determination of the place where a service is rendered is: who is responsible for the payment of VAT? In many cases the taxable person and the payer of the tax are the same person, but in other cases where a non-resident supplier of services is involved the Government of the "importing" country may demand the nomination of a fiscal representative who will be responsible for the payment of VAT or it may introduce legislation under which it can collect the VAT from the receiver. However, with respect to the services which we have described as being mainly of an intellectual nature (Sixth Directive, Article 9.2.e.), it is the receiver who is the sole person from whom VAT can be collected.

With respect to the manner in which VAT can be recouped or refunded the Sixth Directive contains provisions to the effect that the taxpayer can receive full reimbursement for any VAT paid. According to the speaker the refund procedure as laid down in the Eighth Directive will have little significance for persons rendering services.

*Mr. Lebrun (France)*

The speaker indicated that because of the difficulties which arose from the use of the *place of utilization* when determining the place where a service is rendered, it was the original idea of the Commission to turn either to the concept of *supplier* or *receiver of a service* as a decisive factor. However attractive these juridical concepts may be, there remains the economic reality that VAT is a consumption tax which is destined to be shifted on to the consumer. For this reason a realistic approach is needed, which, as Mr. Guieu indicated, has resulted in a compromise.

How have the tax administrations reacted vis-à-vis the problems connected with the definition of place where a service is rendered?

An important problem relates to the definition of certain services enumerated in Article 9 of the Sixth Directive which are not subject to VAT in the country where the supplier is established. These services include the renting of real property and services connected with such property, services connected with transportation and a number of intellectual services and operations connected with the sale or licensing of copyrights.

With respect to the renting of means of transportation no fundamental difficulties have yet been encountered. A problem might arise, however, with respect to the definition of domicile of the taxpayer or the definition of his permanent establishment. The approach followed by the Sixth Directive with respect to services connected with real property seems to be realistic. It is sensible to subject these services to VAT in the country where the

* This summary has been made by the Editors of the Bulletin who are solely responsible for its contents.

property is situated and make no exceptions. Otherwise an absurd situation might exist under which some of these services would be taxable in one country and others in another country. It is for the same reason that all services connected with transportation — loading, unloading, the handling of merchandise etc. — follow the same rules as those which apply to transportation services.

The most important difficulty in the field of cultural, educational and similar services is, according to the speaker, to be found when training foreign personnel, since in many cases such training is a corollary to export operations. It would be in the spirit of the Commission to treat such training in the same manner as an "exportation".

Cultural services are in most cases rendered in the country where the performer is established. However, difficulties of an administrative nature may arise where a foreign performer is only present in a country for a short time. Collection of tax may in such cases prove to be difficult. It is for this reason that the national delegates have sometimes posed the question whether it was worth returning to the "place of utilization" as a criterion in some of these cases.

A second field of problems related to the rendering of intellectual services. The speaker indicates that there have been some difficulties with the delimination of publicity transactions. Also, the concept of counselling (in case of patents, in the information field, management, etc.) is difficult. Furnishing of information includes, for instance, the use of a computer for tourist information and also for the use by airlines or travel agencies for their terminals and cultural information broadcast by television or radio.

Other problem fields indicated by the speaker include such concepts as the main place of activities of a permanent establishment, the concept of beneficiary in the sense of Article 9.2.c of the Sixth Directive and the definition of taxpayer.

*Mr. Cappelleman (Belgium)*

The speaker's intention was to describe certain problems which the Belgian legislature encountered when introducing the provisions of Article 9 of the Sixth Directive in Article 21 of the Belgian VAT Code.

Para. 2 of Article 21 of the Belgian Code provides, in conformity with the Sixth Directive, that a service is generally deemed to have been rendered in the place where the supplier has established his business or where he has his permanent establishment.

There are, however, a number of exceptions to this rule, in the first place with respect to real property: all services connected with real property (and which have been listed in Royal Decree No. 5) are deemed to have been rendered in the place where the property is situated. This also applies to services rendered by intermediaries for the creation or the establishment of a right in rem or right to enjoy real property and services rendered by real estate agents which were formerly subject to different rules. Services in the form of administering real property also follow the above rule.

A second exception to the main rule is that work performed in connection with tangible movable property is deemed to have been carried on in the place where the good is physically present. In some cases where goods are imported with a view of being processed in Belgium and subsequent re-exportation, an exemption is available provided that certain conditions have been met.

Valuation of movable tangible property located in Belgium is considered to be effected in that country. The question may be asked whether the term "work" means actual physical work or also work of an intellectual nature.

The third exception concerns transportation which is deemed to have been supplied where the transport takes place having regard to the distances covered.

The fourth exception deals with cultural, artistic, scientific, educational and similar services which are deemed to have been rendered in the place where they have been physically carried out. Normally, training of personnel would fall under this rule, although where such training is connected with the exportation of equipment it is defensible that such services would follow the rules for export of merchandise and thus be exempt from Belgian VAT. However, it is doubtful whether the Belgian tax administration will adopt this theory considering that exempt services connected with exportation have been exhaustively listed in the Code and such training schemes are not included. However, the supplier of the training may invoice the non-resident customer for the training of his personnel, using an invoice which will show Belgian VAT for which the customer may claim a refund.

Services rendered by cafes and restaurants are deemed to have been supplied where these establishments are located. If similar services are rendered ancillary to transportation services it is also the place where the services are physically carried out which is decisive for Belgian VAT purposes.

Other services ancillary to transportation which follow the rules applicable to transportation services include loading, unloading and handling of merchandise as well as: weighing, measuring, receipt of merchandise, including quantity and quality checks, the taking of samples, etc. However, where these services are connected with importation and exportation they will in many cases be exempt.

A rather controversial criterion is the one which applies to the renting of movable tangible goods (except means of transportation). This type of service is deemed to be rendered where the supplier has his business, unless he is established in a Common Market country and exports the good to another Common Market country where it will be utilized. In that case the place of utilization is decisive. A second exception to the general rule is that the place of utilization is also decisive if the lessor is established outside the Common Market. These rules have caused a number of problems in Belgium, which may be illustrated by the following case.

A Dutch company purchases equipment in the Netherlands which is rented to a Belgian company for which purpose the equipment is exported to Belgium. In this case VAT is due in Belgium. However, if the Dutch company purchases identical equipment in Belgium for renting to its Belgian customer there is no question of exportation so that the main rule applies, i.e. the service is in principle subject to VAT in the Netherlands. This rather bizarre situation will be remedied when the Tenth Directive on VAT has been adopted.

Another exception applies to means of transportation rented to third persons. According to the Sixth Directive the place where such a service is rendered is the place of business of the lessor. However, the Sixth Directive permits Member States to deviate from this rule for the renting of movable tangible goods in two cases: (i) if the place of service (according to the provisions of the Sixth Directive) is located in the Common Market but the good is used outside the Common Market, and (ii) if the place of service is located outside the Common Market but the good is used inside the Common Market. In those cases, Member States may use the criterion of place of utilization and Belgium has indeed made use of this facility. To give a concrete example: if a person rents a car for travel abroad he will be subject to Belgian VAT for that part of his journey in Belgium and the other Common Market countries, but will be exempt for the distance covered outside the Common Market. On the other hand, if a person rents a car outside the Common Market and visits Belgium he is in principle subject to VAT with respect to the use of the car in Belgium, although collection of the VAT will not be a simple matter.

The last exception to the main rule discussed by the speaker concerns the "export" of certain services (which are sometimes indicated as "intellectual" services) in the sense of Article 9.2.e. of the Sixth Directive. In those cases the service is deemed to have been rendered in the place where the customer has established his business. These services include advertising services which include any advertisement, whether for the sale of real property or for the hiring of personnel. The concept of intellectual services proper (services performed by legal counsel, accountants, engineers, research centers, etc.) is taken very broadly by the Belgian tax administration since these services, if exported, are normally used by entrepreneurs. Thus, in case of export of those services they will in most cases be exempt under the provisions based on Article 9.2.e. which is preferred over the cumbersome refund procedure of Article 17 (4°) to which entrepreneurs are entitled. Finally, the place where the customer has his business establishment is also used as the criterion for banking and financial services in the cases described in Article 9.2.e. of the Sixth Directive, as well as for the supply of personnel and for services of agents when they procure for their principal the services enumerated in the above article.

*Mr. Prussen (Luxembourg)*

The text of the Luxembourg VAT law after its adjustment to the provisions of the Sixth Directive only entered into force on January 1, 1980 so that the experience with the new provisions is rather limited.

As prescribed by the Sixth Directive the place where a service is deemed to be rendered is where the supplier has his business establishment or his permanent establishment or, in the absence of this criterion, the place where he has his domicile. The term "permanent establishment" is defined as for the direct (e.g. income) tax.

The situation with respect to the first exception, i.e. for real property, is not as simple as it seems, Assume, for instance, that an engineering bureau established in Paris gives advice with respect to the purchase of real property located in Germany for a Japanese firm established in the United Kingdom. VAT with respect to this service will be due in Germany even where the purchase of the property is eventually not effected.

In some cases (covered by Article 9.2.e. of the Sixth Directive) Luxembourg VAT law deems the place where a service is rendered the place where an *essential* part of the service has physically been carried out. Difficulties may arise with the definition of "essential part". For instance, an expert established in a country is invited to value a movable object located in another country. Where is the essential part of the transaction effected? In the country where the contract has been concluded? Or the country where the good in question is located? Or where the expert discussed the case with his principal? Or perhaps the country where the actual intellectual work, the writing of a report, was performed?

The third exception to the general rule is where the place of utilization determines the places where a services is rendered in the sense of Article 9.2.d. of the Sixth Sirective. The speaker points out that this exception only covers one special case and there exist numerous transactions which lead to the same economic result to which the general rule (place where the supplier of the service has his business establishment) applies.

The fourth exception is where the place where a service is rendered is determined by the place where the customer has his business establishment in the sense of Article 9.2.e. of the Sixth Directive. The speaker remarked that services regarding real property, even if they could be brought under this article, will follow the rules set for services connected with real property in the sense of Article 9.2.a. of the Sixth Directive.

## SUMMARY OF DEBATES ON THE FIRST SUBJECT *

1. Article 15.13 of the Sixth Directive exempts from VAT the supply of services including transport and ancillary transactions but excluding the supply of services exempted under Article 13, when these are directly linked to the transit or the export of goods, or to the imports of goods benefiting from the provisions of Articles 14.1.b. and c. and 16.1.

This provision has been included in Article 262, Para. 1 of the French General Tax Code which exempts the export of movable goods as well as the rendering of services which are directly connected with such exports. This exemption in particular applies to the lease of means of transportation, of containers, of material used for the protection of the exported merchandise and training of personnel of the foreign customer in connection with the exported goods.

All EEC Member States exempt the lease of means of transportation (or apply a zero rate) but, apart from France, there are doubts with respect to the treatment of training of foreign personnel. It seems that Belgium subjects such services to VAT but with the possibility of refund to the foreign entrepreneur, although another speaker believes that there may be a possibility in Belgian law to exempt these services as an export transaction.

2. With respect to the lease of means of transportation, all EEC Member States in principle apply the general rule, i.e. such services are deemed to be rendered in the place where the supplier has his business establishment. Belgium, France and Germany, however, have made use of the exception laid down in Article 9.3 of the Sixth Directive, i.e. where these goods are used outside the Common Market no VAT will be due and VAT will be imposed where these goods are used in the country but the supplier of the service is established outside the Common Market.

3. With respect to the lease of tank cars (wagons citernes), the general rule applies, i.e. the place of the business establishment of the supplier of the service determines the place where the services are rendered. Belgium, however, applies the two exceptions to the main rule indicated above.

4. With respect to the lease of pallets the rules for the lease of movable tangible goods apply, although it may perhaps be debatable whether they should not fall under means of transportation.

5. Where a French real estate agency requests a similar Swiss organization to investigate real property in Switzerland with a view to purchasing this property, the services rendered by the Swiss supplier will be subject to VAT in France if the purchase is not effected (rules of Article 9.2.e. of the Sixth Directive) and exempt from French VAT where the property is purchased (rule of Article 9.2.a.). Anyway, this seems to be the opinion of the Belgian, French and EEC experts at the meeting, although it was admitted that this solution is not always convenient for the parties concerned.

6. Where a parent company established outside the Common Market renders administrative assistance to its subsidiaries established in the Common Market (including France) based on data furnished by its subsidiaries, the services rendered by the parent will follow the rules of Article 9.2.e. of the Sixth Directive. Thus it would be subject to French VAT with respect to the administrative assistance rendered to its French subsidiary.

7. A Belgian permanent establishment of an American company sells merchandise to a French subsidiary of the American compa-

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ny at the same price for which the French company sells the merchandise to its customers. In order to compensate the French company for its activities the Belgian permanent establishment grants the French company a commission. The French tax administration subjects the commission fee to VAT. In fact, the term "commission fee" is incorrect since the goods become the property of the French company and it should therefore be considered to be increase of the purchase price of the goods which is indeed subject to VAT in France.

8. The question was asked why the EEC in its Sixth Directive has adopted as the main rule for the place where services are rendered the place where the supplier of the service has a business establishment and not the criterion of the place where the customer is established. It was conceded that the latter criterion is also a good one since the VAT is then levied in the country where the customer has the right to credit the tax. However, it would not have been possible to avoid the introduction of a rather large number of exceptions to the main rule.

9. Where a French company utilizes advertisement services in France and charges part of the VAT invoiced to it to a Belgian company, the latter transaction is subject to Belgian and not to French VAT. In practice, the French VAT administration seems to have erroneously imposed French VAT in such a case.

10. The question was raised in what manner a supplier of services may ascertain whether he deals with a person subject to VAT, since this will in a number of cases affect his VAT liability. It seems that all manner of proof will be acceptable, including a statement from the VAT administration of the country concerned. At the moment no VAT identification card exists. In Belgium difficulties may be met in the area of construction since entrepreneurs may have been removed from the list of taxpayers without anybody knowing it. In order to prevent tax fraud the Belgian VAT authorities consider all transactions with a party established in Belgium to be subject to Belgian VAT and leave it to the supplier of the service to show that in his case no VAT is due.

11. It was suggested that a uniform form to be stamped by the VAT authorities be introduced to prove that a person has been subject to VAT. A like form exists under the provisions of the Eighth Directive but there is a real danger that the VAT administration will thus be snowed under with paper work.

12. Upon the contribution of a patent right to a company against shares, no VAT will be due. However, where the transaction is effected against other consideration it will be a taxable service.

## SUMMARY*

of *"Regime applicable to non-resident taxpayers"* by J. Autenne, tax adviser of the Federation of Chemical Industries of Belgium and lecturer at the Catholic University of Louvain.

Non-resident entrepreneurs carrying on business transactions in Belgium are generally subject to VAT in that country. An important issue is whether the taxpayers carry out such operations through a permanent establishment in Belgium or not.

### 1. Taxpayers who possess a permanent establishment in Belgium

A non-resident taxpayer who possesses a permanent establishment in Belgium is treated for VAT purposes as a resident taxpayer.

A permanent establishment is deemed to exist if the taxpayer has in Belgium a branch office or agency or any other fixed place of business, provided that the establishment is managed by a person who is authorized to conclude contracts on behalf of the taxpayer.

The consequences are, inter alia, the following:

(i) The taxpayer must register with the Belgian VAT authorities as soon as he commences business in Belgium and he must report any subsequent changes in his status, including the termination of his activities when deciding to cease his business operations in Belgium.
(ii) He must send his customers invoices in the prescribed form and keep financial records in conformity with Belgian law (a simplified recording system may be used if his turnover does not exceed 15 million Bfrs.).
(iii) He must regularly submit tax returns (normally on a monthly basis, but three-monthly if the turnover does not exceed 15 million Bfrs.) and pay VAT to the Belgian Treasury on the dates fixed by law.

The general rule is that the taxpayer is not required to record any transactions which are not effected through his Belgian permanent establishment. However, if he delivers goods or renders services in Belgium which would, in the absence of a permanent establishment, oblige him to appoint a responsible representative (see below), such transactions must be included in the financial records of his Belgian permanent establishment.

### 2. Taxpayers not possessing a permanent establishment in Belgium

Non-resident entrepreneurs who carry out business transactions in Belgium must generally appoint a responsible representative if they do not possess a permanent establishment in that country. This will, for instance, be the case if the non-resident taxpayer carries on construction or assembly operations in Belgium or if he rents goods in Belgium to other persons. Note also, that where a non-resident taxpayer imports goods into Belgium and indicates himself as the recipient of those goods when paying the taxes at importation (e.g. customs duties and VAT), he is also obliged to appoint a VAT representative, since he will be deemed to re-sell the merchandise involved.

The VAT representative, who may be the non-resident taxpayer's customer or a bank or other financial institution or any other person approved by the Belgian VAT authorities, is severally liable for the VAT liability of his principal. However, he may request the VAT office to limit his responsibilities. However, the non-resident taxpayer may only appoint *one* VAT representative so that such limitation may have consequences for the volume of transactions he carries on in Belgium.

Where a non-resident taxpayer renders services in Belgium the obligation to appoint a VAT representative is often waived. This will, for instance, be the case for:

(i) services of an intellectual nature such as the drafting of reports, checking and supervising, market research, advertising and the sale and licensing of certain incorporeal rights, such as patents, trademarks and copyrights;
(ii) if the taxpayer occasionally renders services other than those designated under (i).

The fact that a non-resident taxpayer is exempted from the obligation to appoint a VAT representative does not necessarily mean that he is also exempt from Belgian VAT. In those cases he must generally pay the tax through the affixing of stamps on the invoices he submits to his customers. This system of payment will in particular be used where the non-resident taxpayer has requested a refund of Belgian VAT charged to him by his suppliers.

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However, in those cases where the non-resident taxpayer does not request such a refund (for instance, because he did not use either goods or services subject to Belgian VAT), the VAT will not be collected from the taxpayer but instead from his Belgian customer. Generally, this situation would occur in the case of rendering services of an intellectual nature.

Special rules apply to international passenger transportation. With the exception of sea or air transportation (which is exempt), passenger transportation effected on Belgian territory is subject to VAT. If the transporters do not have a permanent establishment in Belgium they should normally appoint a VAT representative. However, lacking such a VAT representative the Belgian tax administration usually imposes a lump sum tax ranging from 30 to 600 Bfrs. at the frontier.

## SUMMARY OF PAPERS ON THE SECOND AND THIRD SUBJECTS *

*Mr. Cappelleman (Belgium)*

Non-resident taxpayers carrying on taxable transactions in Belgium may be divided into three categories:

1) Those having in Belgium a permanent establishment or a business are subject to the same legal obligations as resident taxpayers.
2) Those who do not have in Belgium a permanent establishment nor a business must in principle appoint a fiscal representative in Belgium who takes care of all administrative and legal obligations. Any VAT due is paid through this representative and any VAT to be refunded is collected through him.
3) Non-residents who have no permanent establishment in Belgium nor a business in that country are exempt from the obligation to appoint a fiscal representative in case of exempt export transactions, isolated transactions and the rendering of services which are subject to VAT in the country where the customer is established.

Where services are subject to VAT in the country where the customer is established, the tax is directly collected from the latter, although the non-resident supplier of the service may be severally liable. If the non-resident supplier has incurred VAT invoiced to him by a Belgian supplier he is entitled to a refund, provided that a Belgian taxpayer would also be eligible for such a refund under the same circumstances. However, there exist some limitations with respect to the refund, inter alia, where vehicles for the transportation of persons and investment goods are concerned. In fact, Belgian VAT legislation, with respect to refund of VAT, is more generous than the Eighth Directive which prescribes such refund only in those cases where the non-resident does not carry on taxable operations in the country which has to make the refund. The Eighth Directive prescribes, further, that VAT must be refunded to non-resident taxpayers who perform exempt transportation services in another Member State, which is a situation also covered by current Belgian VAT legislation. Therefore, Belgian VAT law does not need to be much amended in order to adjust it to the provisions of the Eighth Directive.

*Mr. Lebrun (France)*

Non-resident entrepreneurs rendering services in France are in principle obliged to appoint a fiscal representative in France who must be accepted by the French tax administration. This representative is subject to all obligations to which any other taxpayer is subject, like the preparing of invoices and the keeping of records of the transactions performed. However, the tax administration permits the non-resident entrepreneur to prepare the invoices providing that the name of the fiscal representative is indicated. Where services rendered by a non-resident are subject to VAT in France and are collected from the customer, the formalities with which the supplier of the services must comply are reduced to a minimum. He will in such a case only be severally liable for the payment of the VAT due.
The speaker stated that starting from January 1, 1981 France will fully apply the Eighth Directive on the refund of VAT.

*Mr. Prussen (Luxembourg)*

Where a non-resident entrepreneur has a business or permanent establishment in Luxembourg, approximately similar rules apply as in Belgium. However, there are some slight differences, in particular with respect to those services whereby VAT should be collected from the customer under the provisions of Article 21 of the Sixth Directive. The Luxembourg VAT only authorizes the Government to introduce such rules but no further regulations have been issued. Thus, under current law it is always the non-resident supplier of the services who must submit the VAT returns and make the payments.

However, non-resident suppliers of services performed in Luxembourg are not necessarily obliged to appoint a fiscal representative in that country. In many cases the customer may take over the obligation to pay VAT or the supplier may put up collateral. With respect to refund of VAT the speaker stated that currently the Luxembourg tax authorities demand that the supplier of the services file the VAT returns himself. No refund is available if the formalities are being taken care of by the customer.

## SUMMARY OF DEBATES ON THE SECOND AND THIRD SUBJECTS *

1. The question was raised whether Belgian enterprises have met with financial difficulties because the collateral demanded by the Luxembourg VAT authorities and which must be placed with a Luxembourg financial institution is very substantial. *Mr. Prussen* replies that it is not obligatory to put up collateral and that the non-resident supplier can always propose to appoint a fiscal representative instead. In many cases the customer will be prepared to act as such a fiscal representative.

2. It was further asked whether fiscal representatives do normally demand compensation for their services. *Mr. Cappelleman* has no personal knowledge of such situations but he believed that a remuneration will be asked.

3. It was agreed that the formalities imposed on non-resident entrepreneurs are financially burdensome and time consuming. However, no VAT system is in itself watertight and the VAT authorities need these formalities to combat tax fraud. *Mr. Guieu* pointed out that the EEC Commission did its utmost to draft the Sixth Directive in such manner that no fiscal representative would be needed but unfortunately not all its proposals were accepted. However, the Eighth Directive will further reduce the number of cases wherein a fiscal representative must be appointed.

4. Taxpayers who are exempt from VAT (e.g. hospitals) may cause a problem where they receive services from a non-resident supplier and become liable to the payment of VAT on such services. In Belgium, payment is effected through the affixing of stamps and it was thought that administrative checks were possible. In France such taxpayers, when exempted, are often subject to investigation by public authorities representing the State. Luxembourg does not yet have rules under which the customer is subject to VAT.

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5. The following question was asked: a Belgian company possesses a permanent establishment in France. It rents a tank car to be used in Belgium from a lessor in France. In this case French VAT is due. Is this VAT refundable? The reply was: yes under the provisions of the Ministerial Decree of September 29, 1979. When the Eighth Directive is in force, a refund will be available under the provisions of that Directive.

6. The next question was: a Belgian company acts as an agent for the account of a Canadian customer, soliciting sales for this customer. Sales are effected in Belgium and abroad. The merchandise is sent to the final customer but not from a warehouse situated in Belgium. The reply was: in such a case no Belgian VAT is due.

7. What possibilities exist for a taxpayer in case the VAT authorities of two EEC Member Countries have different interpretations of VAT law? The following solutions may be available:

(i) If the text of the VAT Directive is ambiguous, resulting in differing legal provisions or differing interpretations in two or more countries, the taxpayer may request his VAT administration to submit the problem to the VAT Committee of the EEC Commission. In this manner a certain uniform interpretation may be reached.

(ii) If there is litigation the taxpayer may file a complaint with the EEC Commission which then examines the situation and may open the procedure of Article 169 of the Rome Treaty for violation of the Treaty. The taxpayer may also request the national court to let the Court of Luxembourg render a preliminary decision.

As of January 1, 1981 the Directive on mutual assistance will come into effect and from then on the tax administrations of the countries concerned may attempt to solve the problem bilaterally.

8. The last question concerned services rendered by itinerant traders (e.g. cobblers) and having no fixed domicile or permanent establishment. Admittedly, these persons, when performing taxable services, will be difficult to assess to VAT and in many cases they may benefit from relief accorded to small entrepreneurs.

## ERRATUM

The article by Howard M. Liebman, "Allocations of foreign blocked income under United States tax law", in the June 1980 issue of the Bulletin contains a serious printing error which distorts the meaning of the article. Please read on page 253, left column, 18th line from bottom: "The Sixth Circuit refused to accept this argument, however, and reversed the decision of the court below. The Circuit Court cites a number of decisions, including *First Security Bank of Utah,* for the principle that a taxpayer need not arrange its affairs so as to maximize its tax liability.[25]" The underlined part was omitted in the article.

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Explanation in French of the major features of the German tax system, such as individual and corporate income tax and value added tax. The book also contains an overview of the international aspects of German tax law. Tax tables of the income tax and translations of legal provisions of interest to foreign taxpayers are appended. (B. 102.595)

### THE GERMAN COMMERCIAL CODE

As amended to January 1, 1978. By Simon L. Goren and Ian S. Forrester. Littleton, Fred B. Rothman & Co., 1979. 210 pp.
English translation of and annotations to the German Commercial Code, effective as per January 1, 1978. (B. 102.572)

### GRUNDSÄTZE ORDNUNGSMÄSSIGER BILANZIERUNG FUR BETEILIGUNGEN

By Eberhard Weber. Düsseldorf, IdW Verlag, 1980. Schriften der Schmalenbach-Gesellschaft, Band 7. 278 pp., 48 DM.
Monograph forming part of a series which studies the basic principles of drafting the balance sheet in a regular way; the present work emphasizes participations in companies and other enterprises. (B. 102.573)

HANDBUCH DER FINANZWISSENSCHAFT

Dritte, gänzlich neubearbeitete Auflage unter Mitwirkung von Norbert Andel und Heiz Haller. Herausgegeben von Fritz Neumark. Lieferungen 27-30. Tübingen, J.C.B. Mohr (Paul Siebeck), 1980. 320 pp., 95.40 DM.
Third revised edition of a handbook on public finance prepared by Norbert Andel and Heinz Haller and edited by Fritz Neumark. The present supplements deal particularly with parafiscal budgetary revenue and the theory of public indebtedness. (B. 102.589)

HANDBUCH DER STEUERVERANLAGUNGEN 1979

Einkommensteuer, Körperschaftsteuer, Gewerbesteuer, Umsatzsteuer. Munich, Verlag C.H. Beck, 1980. 2700 pp., 124 DM.
Annual guide for filing 1979 returns for individual income tax, corporate income tax, business tax and turnover tax.
(B. 102.674)

STEUERBERATER — JAHRBUCH 1979/80

Edited by Franz Hörstmann, Ursula Niemann en Gerd Rose. Cologne, Verlag Dr. Otto Schmidt, 1980. 582 pp., 89 DM.
Proceedings and lectures of the 31st congress of German tax advisers held in 1979. Congress topics dealt, inter alia, with tax policy from the point of view of the "Länder", the new 1980 Turnover Tax Law, possibilities to set up private old age pensions, tax problems with respect to the finishing of business activities, the available net worth and corporate income tax, etc. (B. 102.570)

DIE VERANLAGUNG ZUR EINKOMMENSTEUER FÜR 1979

Einkommensteuergesetz, Durchführungsverordnung, Richtlinien, Anlagen, Rechtsprechung, Nebengesetze, Tabelle, Stichtwortverzeichnis. Düsseldorf, IdW-Verlag, 1980. 1259 pp., 36 DM.
Annual guide for purposes of filing individual income tax return for 1979 assessment year. Relevant text of statutes is appended.
(B. 102.591)

DIE VERANLAGUNG ZUR GEWERBESTEUER FOR 1979
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DIE VERANLAGUNG ZUR GEWERBESTEUER FÜR 1979

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Annual guide containing the text of the business tax law, the regulatory ordinance to the business tax law, case law and other relevant material for the 1979 tax assessment year. (B. 102.593)

DIE VERANLAGUNG ZUR KÖRPERSCHAFTSTEUER FÜR 1979

Körperschaftsteuergesetz, Durchführungsverordnung, Richtlinien, Anlagen, Rechtsprechung, Nebengesetze, Stichwortverzeichnis. Düsseldorf, IdW-Verlag, 1980. 607 pp., 29 DM.
Annual guide containing the text of the corporate income tax law, the regulatory ordinance to the corporate income tax law, case law and other relevant material for the 1979 tax assessment year. (B. 102.592)

DIE VERANLAGUNG ZUR UMSATZSTEUER FÜR 1979

Umsatzsteuergesetz, Durchführungsverordnung, Anlagen, Rechtsprechung, Nebengesetze, Stichwortverzeichnis. Düsseldorf, IdW-Verlag, 1980. 1378 pp., 44 DM.
Annual guide for purposes of filing turnover tax return for 1979 assessment year. Relevant text of statutes is appended.
(B. 102.594)

## GUATEMALA

TAXATION IN GUATEMALA

International Tax and Business Service. New York, Deloitte Haskins & Sells, 1979. 46 pp.
Comprehensive outline of taxation in Guatemala. After an introduction to the tax system, income taxes and other taxes are covered. (B. 15.973)

## HONG KONG

HONG KONG: A TAX HAVEN FOR EVERYONE

By S. Nomine. Hong Kong, Excelsior Publications, Ltd., 1980. 182 pp., HK$14.95.
A pseudonymous author provides a guide for anyone interested in finding ways to reduce taxation, dedicated to all long-suffering taxpayers. Topics include invoicing, reinvoicing and similar operations. Some interesting cases are also presented. (B. 51.567)

## INDIA

CASES ON VALUATION UNDER DIRECT TAX LAWS

Vol. I, 1977 and Vol. II, 1978. By H.G. Agarwal and Rani Kharbanda. Allahabad, Law Publishing House, 1977/78. 786 pp.; 600 pp.
Two bound volumes containing text of case law on valuation under direct tax laws of India, covering annual letting value, assets, estate, gold, goodwill, house property, land, shares, etc.
(B. 51.525/526)

COMMENTARIES ON THE LAW OF INCOME TAX IN INDIA

11th Edition. Volume II (Sections 35-137), 1979-80. By V.S. Sundaram. Allahabad, Law Publishers, 1979. 2272 pp.
Volume II of a four-volume series containing comment on Sections 35 to 137 of the Indian income tax law. (B. 51.563)

DISPARITY TAX IN A COMPOSITE ECONOMY

By Gautam Mathur. Dehli, Macmillan Company of India, Ltd., 1975. 264 pp.
Study explaining the implications of the introduction of an expenditure tax in lieu of an income tax in a planned, guided developing economy where public and private sectors exist.
(B. 51.561)

INCOME-TAX READY RECKONER; ASSESSMENT YEAR 1979-80

With rates tables and examples for: (1) wealth-tax; (2) estate duty; (3) gift-tax; (4) companies surtax; (5) compulsory deposit (taxpayers) scheme. Assessment year 1980-81 for deduction of tax from "salaries" and computation of "advance tax" during the financial year 1979-80. By V.G. Mehta and N.V. Mehta. Bombay, Shri Kuber Publishing House, 1979. 320 pp.
39th Consecutive edition of quick reference guide for the assessment year 1979-80 with respect to major taxes levied in India.
(B. 51.544)

REGISTRATION AND ASSESSMENT OF FIRMS AND THEIR PARTNERS UNDER THE INCOME TAX ACT, 1961

Amended and brought up-to-date including the Taxation Laws Amendment Act, 1975. By Ved Prakash Verma. Allahabad, Central Law Agency, 1976. 458 pp.
Second edition of monograph explaining registration of firms under the Income Tax Act of India. (B. 51.562)

## INDONESIA

INFORMASI

Peraturan perundang-undangan Republik Indonesia. Jakarta, Pusat Dokumentasi Hukum, 1979. 400 pp.
Sourcebook entitled "Information" containing all statutes of the Republic of Indonesia promulgated in 1978, compiled by the Pusat Dokumentasi Hukum (Documentation Law Centre), Faculty of Law of the University of Indonesia, Jakarta. (B. 51.566)

LIST OF PRIORITY SCALES FOR FIELDS OF FOREIGN INVESTMENT FOR THE YEAR 1980

Daftar skala prioritas bidang usaha penanaman modal dalam negeri tahun 1980. Jakarta, Badan Koordinasi Penanaman Modal (Investment Coordinating Board), 1980. 60 pp. (B. 51.533)

## INTERNATIONAL

### THE DIALOGUE BETWEEN THE TAX ADMINISTRATION AND THE TAXPAYER UP TO THE FILING OF THE TAX RETURN

XXXIVe Congrès International de droit financier et fiscal, Paris, 1980. Deventer, Kluwer, 1980. Cahiers de droit fiscal international, Volume LXVa. 444 pp.
Analysis by Huy Delorme, the general reporter, on the national reports contributed by the various authors on the title subject. A summary of each report in English, French, German and Spanish is appended. National reports include the following countries: German Federal Republic, Argentina, Australia, Austria, Belgium, Canada, Colombia, Denmark, U.S.A., France, Greece, Hong Kong, Israel, Norway, the Netherlands, Portugal, United Kingdom, Sweden, Switzerland, Uruguay. (B. 102.699)

### EAST-WEST INDUSTRIAL CO-OPERATION

New York, United Nations, 1979. 122 pp. (B. 102.705)

### ESTUDIOS DE DOBLE IMPOSICION INTERNACIONAL

Edited by José Maria de la Villa. Madrid, Instituto de Estudios Fiscales, 1979. 395 pp.
Studies by various authors on aspects of international double taxation. Problems in the OECD Model Convention are considered. (B. 102.697)

### INTERNATIONAL MONETARY FUND

Summary proceedings of the thirty-fourth annual meeting of the Board of Governors, October 2-5, 1979. Washington, International Monetary Fund, 1979. 376 pp. (B. 102.623)

### KENNIS VAN ZAKEN

Aspecten van know-how-recht in de Europese Gemeenschap en de Verenigde Staten. Know-how-law in the European Community and the United States. By Petrus Johannes Idenburg. Deventer, Kluwer, 1979. 247 pp.
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By Mark Daniel. London, Gee & Co. (Publishers) Limited, 1980. 128 pp.
Guide primarily intended for accountants, discussing pension planning schemes with reference to tax advantages. (B. 102.688)

### LES REGIMES FISCAUX VISANT A ENCOURAGER LES INVESTISSEMENTS DIRECTS ET DE PORTEFEUILLE DANS LES PAYS EN VOIE DE DEVELOPPEMENT

L'interaction du système fiscal zaïrois et des régimes préférentiels des pays de l'O.C.D.E. By Lofumbwa Bokila. Louvain, Université Catholique de Louvain, 1980. 309 pp.
Thesis on tax regimes designed to encourage direct and portfolio investments in developing countries. The interaction of the tax systems between capital importing and exporting countries is taken into account with emphasis on the tax system in Zaire and possible developments in the industrialized OECD countries.
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Congress report for the International Fiscal Association containing general report and national reports on the title subject. A summary of each report in English, French, German and Spanish is appended. The report by the general reporter, Robert J. Patrick Jr., is printed in full in the four languages. National reports include the following countries: South Africa, German Federal Republic, Argentina, Australia, Austria, Belgium, Canada, Colombia, Spain, U.S.A., Finland, France, Greece, Hong Kong, Israel, Italy, Japan, Luxembourg, Mexico, New Zealand, the Netherlands, Portugal, United Kingdom, Switzerland. (B. 102.699)

## ITALY

### I.V.A.

Milan, Banco Commerciale Italiana, 1980. 1161 pp.
Compilation of statutes concerning VAT. (B. 102.638)

## JAPAN

### GUIDE TO JAPANESE TAXES 1979-80

By Gomi Yuji. Tokyo, Zaikei Shobo Sha, 1979. 278 pp.
Annual updated information on Japanese taxes levied as of April 1, 1979. (B. 51.353)

### OECD ECONOMIC SURVEYS: JAPAN

Paris, Organisation for Economic Co-operation and Development, 1980. 87 pp. (B. 102.383)

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### FUNDAMENTALS OF INCOME TAXATION IN KENYA

By Ngotho Wa Kariuki. Nairobi, Midi-Teki Publishers, 1978. 282 pp.
Textbook on income tax in Kenya, with exercises at the end of each chapter. (B. 13.055)

### FOREIGN INVESTMENT IN A DEVELOPING ECONOMY

Prepared and published by Business International, Geneva, 1980. 166 pp.
Monograph on Kenya describing foreign investment opportunities, including labour law and taxes. Appended are the texts of relevant laws (such as the Foreign Investment Protection Act) and addresses of relevant institutions. (B. 13.060)

## MALAYSIA

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By the Economic Research and Statistics Department. Kuala Lumpur, Bank Negara Malaysia, 1979. 437 pp.
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Introductory information to doing business in Mexico dealing, inter alia, with taxation. (B. 15.977)

## THE NETHERLANDS

### BELASTINGWETTEN

Elfde druk 1980. Deventer, Kluwer, 1980. 526 pp.
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A summary. The Hague, Ministry of Finance, 1979. 28 pp.
Description of the corporate income tax, individual income tax and net wealth tax in the Netherlands and related taxes such as wages tax, dividend tax. (B. 102.644)

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Uitgave 1980 bestemd voor de aangifte over 1979. 10de jaarlijkse editie. By A.C. de Groot and W.H. van der Meer. Amsterdam, Annoventura, 1980. 216 pp., 34.50 Dfl.
Tenth annual edition of guide providing information for filing corporate income tax returns for 1979 (B. 102.620)

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Tweede Lustrumcongress Tilburgse Fiscalistenvereniging "De Smeetskring". Deventer, Kluwer, 1980. 58 pp.
Proceedings and reports of a conference of tax experts dealing with real estate tax levied by municipalities in the Netherlands. (B. 102.587)

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Study analyzing the concepts of income and net wealth and their distribution among the population, as affected by taxation. (B. 102.622)

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En andere verhalen waarin het belastingrecht een bescheiden plaats inneemt. By Laurent J.M. Nouwen. Utrecht, Coöperatieve Centrale Raiffeisen-Boerenleenbank, 1979. 52 pp.
Collection of short stories in which taxation plays a discreet role. (B. 102.548)

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14e Druk, 1 januari 1980. By H.J. Doedens. Deventer, Kluwer, 1980. 20 pp.
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By G.J. van Leijenhorst. Deventer, Kluwer; The Hague, Fenedex, 1980. Serie "Fiscale en juridische documentatie voor internationaal zakendoen", No. 7. 130 pp.
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1979-80 BUDGET NOTES FOR GUIDANCE ON COMPANIES INCOME TAX

Lagos, Federal Inland Revenue Department, 1979. 13 pp. (B. 13.061)

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31ST ANNUAL REPORT OF THE TRUST TERRITORY OF THE PACIFIC ISLANDS, OCTOBER 1, 1977 TO SEPTEMBER 30, 1978

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COUNTRY STUDY ON MICRONESIA

For presentation to the Second Seminar on Foreign Investment and Tax Administration of the U.N. Economic Social Commission for Asia and the Pacific, September 27 to October 7, 1976, Tokyo, Japan. By Elizabeth S. Udui and Eulogio S. Inos. Saipan, Trust Territory of the Pacific Islands, 1976. 78 pp.
The study on foreign investment was prepared by Mrs. Udui, that on tax administration by E.S. Inos. (B. 51.509)

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Comments on the new Income Tax Ordinance of 1979 (which replaced the Income Tax Ordinance of 1922), the Finance Ordinance of 1979 and amendments in business laws affecting commerce, trade and industry. (B. 51.545)

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### TAX POLICY IN PAPUA NEW GUINEA

By Robert Neild. Published by the Institute of National Affairs. P.O. Box 3530, Port Moresby, Papua New Guinea, 1979. I.N.A. Discussion Paper, No. 4. 82 pp. (B. 51.517)

## PHILIPPINES

### THE EFFECTS OF INFLATION ON THE PHILIPPINE INDIVIDUAL INCOME TAX STRUCTURE

Overview of Metropolitan Manila Public Finance. Manila, National Tax Research Center, 1978. NTRC Staff Papers, December 1978. 94 pp. (B. 51.559)

### TAX REFORMS INTRODUCED BY THE INTERIM BATASANG PAMBANSA

(June 12, 1978 — December 31, 1979). By Angel Q. Yoingco. Manila, National Tax Research Center, 1980. 18 pp.
Highlights and brief comments on enactments during the period June 12, 1978 to December 31, 1979. (B. 51.549)

## SAUDI ARABIA

### LEGAL ASPECTS OF BUSINESS IN SAUDI ARABIA

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Monograph explaining the current state of commercial law and business practice in the Kingdom of Saudi Arabia as well as the early laws of Islam. Tax and related laws are dealt with. English translations of relevant statutes are appended. (B. 51.564)

## SINGAPORE

### ANNUAL REPORT 1978

Inland Revenue Department, Republic of Singapore. Singapore, Inland Revenue Department, 1978. 69 pp. (B. 51.536)

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Each topic is introduced with selected cases and materials dealing with securities regulation law of Singapore and Malaysia. Topics include: public floatation, unit trusts and investment companies, sharebroker and client relationship, insider trading takeovers. (B. 51.528)

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Informative guide for doing business in South and Central America, also dealing with taxation. The countries covered are: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Guatemala, Mexico, Panama, Peru, Uruguay, Venezuela. (B. 15.976)

## SPAIN

### DERECHO FINANCIERO Y TRIBUTARIO

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### INVESTITIONEN IN SPANIEN

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Annual report of the Spanish branch of the International Fiscal Association with respect to 1978 activities (both national and international). (B. 102.694)

### EL REGIMEN TRANSITORIO DE LA IMPOSICION INDIRECTA

By Alejandro Pedros Abello, Agustin Bas Serra and Joaquin Vila Calsina. Barcelona, Marcombo, 1980. 92 pp.
The consolidated texts of the turnover tax law and the luxury tax law, which have a transitional function, are printed. A short introduction is included. (B. 102.695)

### DAS SPANISCHE ZIVILGESETZBUCH

By Witold Peuster. Cologne, Bundesstelle für Aussenhandelsinformation, 1979. Schriftenreihe "Ausländisches Wirtschafts- und Steuerrecht", Band 55. 530 pp.
German translation of the text of the Spanish civil code of 1889, in the amended version of 1978. (B. 102.693)

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Grundsätze sowie Besteuerung im Verhältnis Schweiz-U.S.A. By Ruedi Baumann. Zürich, Ruedi Baumann, 1979. 456 pp.
Study on the principles and taxation of income from international associated companies, in particular with respect to Switzerland-U.S.A. companies. (B. 102.692)

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Loose-leaf publication on tax relief granted by comprehensive double taxation treaties concluded by Switzerland with other countries concerning dividends, interest, royalties, private pensions and other income. Schedules, explanation and forms for each concluded double taxation treaty are appended. The same is available in the French language. (B. 102.599/600)

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Second edition. Second cumulative supplement. By John Tiley. London, Butterworths, 1979. 68 pp., £3.95. (B. 102.689)

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Including federal income taxes of estates and trusts (sub-chapter J). Chicago, Commerce Clearing House, Inc., 1980. 830 pp. $8.50.
Complete texts of the estate and gift tax and the tax on certain generation-skipping transfers, as well as corresponding official regulations. (B. 102. 690)

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Chicago, Commerce Clearing House, Inc., 1980. 174 pp., $5. (B. 102.691)

### INDIVIDUAL RETIREMENT PLANS

Individual retirement accounts; individual retirement annuities; government retirement bonds, simplified pension plans. Chicago, Commerce Clearing House, Inc., 1980. 32 pp., $1.50.
Discussion of several retirement related tax problems. (B. 102.647)

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As of May 1, 1980. Alcohol, tobacco, and excise tax provisions, including windfall profit tax. Chicago, Commerce Clearing House, Inc., 1980. 250 pp., $3.50. (B. 102.669)

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Proceedings of the fifty-third annual meeting, held in Philadephia, Pennsylvania, October 14-17, 1979. Washington, Federation of Tax Administrators, 1979. 134 pp. (B. 102.666)

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Law and Explanation. Enacted April 1, 1980. Chicago, Commerce Clearing House, Inc., 1980. 184 pp., $6.
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## I. ARTICLES

# Conference Diary

## NOVEMBER 1980

*Confédération Fiscale Européenne (C.F.E.):* Second Congress of European Tax Consultants (subject: "La pratique de la Fiscalité en Europe"), Rome (Italy), November 6 and 7 (English, French, German).

*Management Centre Europe:* International Tax Management Seminar (Discussion of tax problems in today's multinational environment), Munich (German Federal Republic), November 10-11 (English).

*Seminar Services International:* Two International Tax Conferences. (1) Direct Investment between Major European Countries (including: General Introduction to the Taxation Aspects of Cross Frontier Corporate Investment, Harminization of Corporate Tax Systems in the EEC); (2) Direct Investment into the United States (including: U.S. Taxation of Foreign Investors). London (United Kingdom), November 10-11 (English).

*International Tax Planning Association:* Bahamas (Caribbean Seminar) (including: How Canada Views the Bahamas and other Tax Havens; How the U.S.A. Views the Bahamas and other Tax Havens), Nassau (Bahamas), November 10-13 (English).

*Management Centre Europe:* Managing and developing foreign subsidiaries (including: Tax in international operations), Munich (German Federal Republic), November 12-14 (English).

*The American Tax Institute:* New Developments in Euro-American Taxation (including: Tax Havens and Treaty Shopping in Light of Current Treasury Department Activities in the Treaty Area), Cannes (France), November 24-26 (English).

*Management Centre Europe:* Leasing Seminar (including: Tax aspects of leasing), Brussels (Belgium), November 26-28 (English).

## DECEMBER 1980

*Management Centre Europe:* International cash management (including: International tax aspects in cash management), London (United Kingdom), December 8-10 (English).

## FEBRUARY 1981

*Management Centre Europe:* International Tax Management (including: Inter-company pricing: licensing, service fees) (Seminar), Brussels (Belgium), February 12-13 (English).

## APRIL 1981

*Management Centre Europe:* Fourth MCE International Tax C

## APRIL 1981

*Management Centre Europe:* Fourth MCE International Tax Conference. Chairman: Prof. J. van Hoorn Jr., Co-Chairman: A.G. Davies C.B.E. Main subjects: Transfer pricing; Government and business views on tax avoidance, Taxation of international leasing; small meeting groups directed by members of the faculty, Munich (German Federal Republic), April 8-10 (English).

## SEPTEMBER 1981

*35th Annual Congress of I.F.A.:* I. Mutual agreement procedure and practice, II. Unilateral measures to prevent double taxation, Berlin (German Federal Republic), September 21-25 (English, French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

Confédération Fiscal Européenne, Secrétariat Général (C.F.E.), D-5300 Bonn 1, Dechenstrasse 14, German Federal Republic or Siège Social F-75009 Paris, 9 rue Richepase (France).

International Fiscal Association (I.F.A.): General Secretariat, Woudenstein, Burgemeester Oudlaan 50, P.O. Box 1738, 3000 DR Rotterdam (the Netherlands).

International Tax Planning Association, 33A Warwick Square, London SW1V 2AD (United Kingdom).

Management Centre Europe, Avenue des Arts 4, B-1040 Brussels (Belgium).

Seminar Services International, 54 rue du Faubourg Saint-Honoré, F-75008 Paris (France).

The American Tax Institute in Europe, 53, avenue Montaigne, 75008 Paris (France).

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— by *Prof. Dr. Božidar Jelčič*

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— by *N.M. Qureshi*

Perspectives in tax design and tax reform
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Override of tax treaties by ordinary legislation
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# NIGERIA: Capital Transfer Tax

# A Critical Review

by A.C. Ezejelue*

## I. INTRODUCTION

The Capital Transfer Tax Decree [1] introduced the capital transfer tax (CTT) throughout the country with effect from April 1, 1979. The Decree makes provision for the imposition of capital transfer tax on transfer of property inter vivos or on death. It also provides, inter alia, for certain exemptions from the tax and generally for its due administration.

The tax is at a graduated rate on chargeable transfers and the rates [2] vary from 10 to 60 percent on the value of transfers exceeding ₦100,000. The tax is administered by the relevant State Tax Authorities.

One of the main objectives of CTT is to control the colossal acquisition of personal wealth and fortune by the affluent minority in the last few years. [3]

## II. CTT ON TRANSFERS INTER VIVOS

CTT shall be payable under the Decree on the value of any property [4] transferred by any person during his lifetime. [5] However, the tax will not be levied if the transfer is a genuine outright sale of the property and is not intended to confer gratuitous benefit on the transferee. [6] Specifically, the transfer must either be made or be such as might be made in a transaction at arm's length between persons not connected with each other.

In the case of a settlement, where property comprised in a gift inter vivos is property settled by that gift, it is treated as an ordinary gift inter vivos for purposes of CTT. The person to whom the gratuitous transfer is made is accountable for CTT. [7] The transferor is in no way liable.

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### (a) Cumulative transfers

Section 2(1) of the Decree exempts a transferee from CTT where on the date of the transfer the value of the property does not exceed ₦100,000. However, if there are subsequent transfers to the transferee, the value of all the transfers is aggregated, and only the first exemption of ₦100,000 is applied to the cumulative transfers made to the same person. [8] Thus, where gifts of property worth ₦40,000, ₦50,000, and ₦20,000 are made to X on different dates, the value of the property that will attract CTT is ₦10,000 = ₦(40,000 + 50,000 + 20,000 − 100,000). This provision is subject to the exclusion of any property tranferred before the coming into effect of this Decree. [9]

As a corollary, the emphasis is not on the total value of gratuitous gifts by any person to a number of donees during his lifetime, but on the cumulative and total

* Senior Lecturer in Accounting and Acting Head, Department of Accountancy, University of Nigeria.

1. No. 12 of 1979.
2. Sec. 18. See footnote 22, below.
3. General Olusegun Obasanjo, "1979/80 Federal Budget", *New Nigerian*, April 2, 1979, pp. I-IV.
4. According to Sec. 28, "property" includes money and all interests capable of being held in land, and personal property and the proceeds of sale thereof, respectively, and any money or investment for the time being representing the proceeds of sale.
5. Sec. 1(1).
6. Sec. 1(2).
7. Sec. 1(3).
8. Sec. 2(2).
9. Sec. 2(3).

transfers to each donee. Thus, assume that the sum of the value of all transfers made by Obinna after April 1, 1979 is as follows:

| | |
|---|---|
| To Chizoba | ₦45,000 + ₦30,000 + ₦50,000 |
| To Ifeyinwa | ₦60,000 + ₦25,000 |
| To Chinasa | ₦90,000 |

The value of the property subject to CTT is only ₦25,000 = ₦(45,000 + 30,000 + 50,000 − 100,000) to Chizoba. The first ₦100,000 value of gifts to Chizoba is specially exempt and the gifts to Ifeyinwa and Chinasa are also exempt as each is cumulatively less than ₦100,000.

### (b) Title to property and valid registration

In order to ensure that CTT is paid by the person accountable for the tax. Section 3 provides that the title to property transferred inter vivos and which is liable to CTT shall not pass to the transferee until the tax has been paid. It further provides that where an instrument effecting the transfer is registrable under any law in Nigeria, such instrument shall not be registered unless the Relevent Tax Authority has issued a certificate of clearance evidencing payment of such tax. Any registration made without the discharge certificate having been issued shall be void ab initio and of no effect whatsoever.

## III. CTT IN RESPECT OF TRANSFERS ON DEATH

Section 4 provides that CTT shall be imposed on the value of all property passing on the death of a person. In order to determine the rate of CTT payable on any property passing on death, all such property situated within a State is aggregated to form one estate for the purposes of the tax. [10]

### (a) Property deemed to pass on death

Section 5 includes the following property as passing on the death of the deceased:

(i) Property in which the deceased was at the time of his death competent to dispose.

(ii) Property in which the deceased or any other person had an interest ceasing on the death of the deceased, to the extent to which a benefit accrues or arises by the cesser of such interest.

(iii) Any property taken as donatio mortis causa (i.e. gift in contemplation of death) made of taken under a disposition made by the deceased, purporting to operate as an immediate gift inter vivos whether by way of transfer, delivery, declaration of trust or otherwise but exclusive of any such property in respect of which CTT had been paid during the lifetime of the deceased.

For a donatio mortis causa to be valid the following conditions should be expected to be satisfied:

- It must be made in contemplation of the death of the donor. If a gift is made in contemplation of suicide it is void for being repugnant to public policy. [11]
- The condition that the gift must be by way of delivery, transfer, declaration of trust or otherwise is met if there is an antecedent delivery of the chattel alio intuitu to the donee before the date of the gift. [12] In *Re Lillingstone* [13] it was held that if the property was bulky and could not be transferred, the provision of the means of making use of it or taking delivery thereof was sufficient.
- The circumstances are likely to be such as to establish that the gift is intended to take full effect only after the death of the donor such that the thing is to revert to the donor (unless the donor indicates otherwise) in case he should recover. [14]

(iv) Any property which the deceased was entitled to and which he has caused or may cause to be transferred to or vested in himself and any other person jointly whether by disposition or otherwise, so that the beneficial interest therein or in some part thereof passes or accrues by survivorship on his death to such other person.
This is reminiscent of an estate held in joint tenancy with one of its peculiar characteristics of jus accrescendi. There might be a problem of survivorship in a case where the joint tenants perish in a common disaster. In this situation it is likely that the common law rule would apply allowing their heirs to hold as joint tenants so that there is no survivorship. [15]

(v) Any property passing under any past or future settlement made by the deceased by deed or any other instrument not taking effect as a will, whereby an interest in such property for life or any other period determinable by reference to death is reserved either expressly or by implication to the settlor, or whereby the settlor may have reserved to himself the right, by the exercise of any power, to restore to himself, or to reclaim the absolute interest in such property.
This creates a reversionary interest whereby the residue of the estate reverts to the grantor upon the determination of the prior estate as opposed to a remainder which stands over for the remainder-man at the end of the particular estate.

(vi) Any annuity or other interest purchased or provided by the deceased either by himself alone or in concert or by arrangement with any other person, to the extent of the beneficial interest accruing or arising by survivorship or otherwise on the death of the deceased.

### (b) Exemptions from CTT

No CTT shall be payable in respect of any family house. [16] Also, no CTT shall be payable in respect of such paintings, manuscripts, works of art or scientific collections as may be donated or bequeathed to any body or institution in Nigeria such as museums, universities or other public institutions as may be specified by the Federal Executive Council. [17]

### (c) Persons accountable for CTT

The executor of the deceased is accountable for the CTT on all personal property wheresoever situate in the

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10. Sec. 7.
11. Re Dudman (1925), Ch.D. 553. See also Agnew v. Belfast Banking Co. (1896), 2 IR 204.
12. Cain v. Moon (1986), 2 QBD 283.
13. (1952), 2 All ER 184.
14. Delgoffe v. Fader (1939), 3 All ER 682.
15. Bradshaw v. Toulmin (1784), Dick, 633.
16. Sec. 17(1). Family house is defined by Sec. 17(2) as any house or part thereof used wholly by a particular family as the principal place of residence for that family and in respect of which no income accrues to such family or any member thereof.
17. Sec. 17(3) and (4).

State concerned of which the deceased was competent to dispose at his death, but shall not be liable for any tax in excess of the assets which he has received as executor, or might but for his own neglect or default have received. [18]

Where by operation of any law property passes on the death of the deceased, and there is no executor, or the executor is not accountable for the CTT in respect of such property, sub-section 2 of Section 11 deems the following responsible for the CTT on the property:

(i) every person to whom any property so passes for any beneficial interest in possession,
(ii) every trustee, guardian, committee or other person in whom any interest in the property so passing or the management thereof is at any time vested, and
(iii) every person in whom the same is vested in possession by alienation or other derivative title.

These are subject to the proviso that a person who acts merely as agent or bailiff for another person in the management of property shall not be held accountable for the tax. Also a bona fide purchaser for value without notice of tax attaching to the property takes the property free from CTT liability.

## IV. ADMINISTRATION AND GENERAL

The Decree is administered by the State in which the property subject to CTT is situated. CTT is under the care and management of the Relevant State Tax Authority charged with responsibility for the assessment and collection of tax on the income of persons resident in that State. [19] In order that the Relevant Tax Authority of the State where the property is situated should exercise jurisdiction over the assessment and collection of the CTT, it is not necessary that the deceased or transferor should be resident for income tax purposes in that State.

Section 9 provides that every person who is accountable for CTT, in the case of transfers on death, shall not later than 12 months after the death of the deceased or six months after the transfer in the case of transfer inter vivos prepare and deliver to the Relevant Tax Authority the CTT Form. While in the case of the former the Form shall contain a true and perfect inventory and account of the estate of the deceased and a statement of the value of the estate, in the case of a transfer inter vivos the Form shall contain a description of the property and a statement of its value.

### (a) Determination of value of property

The value of any property is the estimated price which, in the opinion of the Relevant Tax Authority, the property would fetch if sold in the open market at the time of the death of the deceased or of the transfer of the property. [20] For this purpose, the value can be ascertained by the Relevant Tax Authority in such manner as it thinks fit, such as by appointing valuers.

In determining the value of a deceased's estate for CTT, allowance shall be made, subject to a few exceptions, for reasonable funeral expenses and for debts and incumbrances incurred bona fide for full consideration wholly for the deceased's own benefit.

Where an estate includes an interest in expectancy and CTT on such interest is paid together with the rest of the estate, the value of the interest is that at the date of the death of the deceased. Where, on the other hand, CTT is not paid until the interest falls into possession, the value of the interest is calculated according to its value when it falls into possession. [21]

### (b) Rates of CTT and quick succession relief

The scale of rates of CTT on chargeable transfers is at a graduated rate ranging between 10 and 60 percent. [22] However, Section 19 provides for a reduction of tax in the case of quick succession such as where within ten years of a first death a second death occurs subjecting the same property or any part thereof to CTT for a second time. A tax reduction is given on the death of the donee or legatee based on a percentage, which depends upon how long the donee or legatee survived the gift or legacy, of the rate of tax originally paid on the property by the transferee. The percentages, which decrease with the increase in the length of time the transferee survived the property, range from 80 percent where the second death occurs within twelve months of the first to 10 percent where the second death occurs within ten years of the first death. The quick succession relief avails where CTT becomes payable on any property consisting of land or a business (not being a business carried on by a company), or any interest in land or such a business. Where, however, the value of the property on which the tax is payable on the second death exceeds the value on which tax was payable on the first death, the former value would be used to determine the amount of tax on which the quick succession relief is to be computed.

### (c) Disposition to relatives

Any disposition made by the deceased in favour of his relative [23] shall be treated as a gift unless:

18. Sec. 11(1).
19. Sec. 8(1).
20. Sec. 10(1).
21. Sec. 13(3) (a) and (b). Interest in expectancy may include future interests such as remainders or reversions whether vested or contingent.
22. Sec. 18. The rates are graduated as follows:

| *Net value of the estate or property transferred* | *Rate of CTT* |
|---|---|
| ₦ | % |
| First 100,000 | Nil |
| Next 150,000 | 10 |
| Next 150,000 | 20 |
| Next 250,000 | 30 |
| Next 500,000 | 40 |
| Next 1,000,000 | 50 |
| Thereafter | 60 |

23. See paragraph 1 of Part I of the Schedule to Sec. 6. Deceased's relative means: (i) the wife or husband of the deceased; (ii) the father, mother, children, uncles and aunts of the deceased; and (iii) any issue of any person falling within (i) or (ii) and the

(i) the disposition was made for full consideration in money or money's worth paid to the deceased for his own use or benefit, or

(ii) the disposition was to discharge a fiduciary obligation imposed on him.

Where, however, the consideration for the disposition was only partial, the value of the consideration shall be allowed as a deduction from the value of the property for the purpose of CTT.

### (d) Payment options and recovery actions

Under Section 22, the Relevant Tax Authority may, on the application of any person accountable for CTT, accept any property (including interest in land) in satisfaction of the whole or any part of such tax. However, in order to alleviate the undue strain and excessive sacrifice of lump sum payment of CTT it is provided that the tax authority may, on such terms as it thinks fit, allow payment to be postponed for such interest not exceeding 3 percent. [24] But under certain conditions [25] specified in the Decree, such as the difficulty in ascertaining the exact amount of CTT payable, the Revenue has the power, on the application of any person accountable, to accept by way of composition for all the CTT payable, payment of the sum so assessed in full discharge of all claims for the taxes in respect of such property or interest, and shall give a certificate of discharge accordingly. The certificate shall not, however, discharge any person from any tax in case of fraud or failure to disclose material facts. But under Section 20(3) a discharge certificate in respect of any property included in the certificate shall exonerate a bona fide purchaser notwithstanding any such fraud and failure.

For the purposes of enforcing payment of CTT on any person accountable where that person fails, neglects, or refuses to pay the tax, the tax authority may for the non-payment of such tax distrain:

(i) upon the land, premises or place in respect of which the tax was charged;

(ii) the person charged by his goods or other chattels including money, bills of exchange, bonds or other securities. [26]

The amount of tax unpaid may be recovered by the sale of anything so distrained.

If after the tax has been paid, it appears for any reason that too little tax was paid, an additional tax shall, unless a discharge certificate has been issued, by payable, and be treated as tax in arrears. [27]

As a counterpoise to the provisions on raising additional tax in case of underpayment, the Decree provides that where the tax authority is satisfied that too much tax has been paid, a repayment of the excess shall be made. [28] Where the overpayment was due to overvaluation of the property by the tax authority, the repayment will attract an interest of 3 percent per annum.

### (e) Offences, penalties, and appeals

A person accountable for CTT who violates the provisions of Section 11 such as by his wilful failure to supply required information or to complete correctly the CTT Form shall be guilty of an offence and will be liable on conviction to a fine of a sum equal to double the amount of the CTT, if any, remaining unpaid for which he is accountable. [29] Also if any person makes any statement in a CTT Form which is false in any material particular he shall be guilty of an offence and liable on conviction to a fine of ₦10,000 or to imprisonment for two years. [30]

If any person is aggrieved by the decision of the Relevant Tax Authority with respect to the amount of CTT payable on any property whether on the ground of the value of the property, or the rate charged, or otherwise, he may on payment of 50 percent of the tax assessed, or of such portion of it as is therein payable by him, appeal to the High Court of the State concerned for the determination of the amount of the tax. [31] Any excess payment of tax will be repaid, and the High Court may, where it appears to it just, order the repayment of such excess with interest at 3 percent per annum for such period as appears to the court just. Appeals shall lie from decisions of the High Court in the same manner and to the same extent as appeals from the decisions of the Court in civil proceedings given by that Court sitting at first instance. [32]

## V. REVIEW OF THE OBJECTIVE OF THE DECREE

While introducing the Decree in the 1979-80 Federal Budget the then Head of State, General Olusegun Obasanjo, specifically mentioned the following factors [33] as contributing to the promulgation of the Decree:

(i) the tendency among the youths to regard the material successes of their parents as reasons for not wanting to make any effort to improve themselves and earn their own living;

(ii) the belief that every individual should work for his or her livelihood because that is what self-respect dictates;

(iii) the fact that in the process of working for a living, the individual inevitably makes some contribution to the growth and development of the society;

(iv) the noticeable trend among children and youths in our educational institutions and elsewhere of believing that they should have no ambition and relying on their parents' wealth to see them through life;

(v) the imposition of some measure of control in the acquisition of personal wealth and fortune by the affluent minority in order to avoid future disaffection and social explosion;

(vi) the additional effect of providing, in due course, one more source for financing the economic and social programme of the nation.

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other party to a marriage with any such person or issue. Children and issue include those born out of wedlock and those adopted.

24. Sec. 12(9).
25. See Sec. 16.
26. Sec. 24(1).
27. Sec. 12(7).
28. Sec. 12(10).
29. Sec. 11(4).
30. Sec. 11(5).
31. Sec. 21(1).
32. Sec. 21(2).
33. *New Nigerian*, April 2, 1979, p. IV. columns 3 and 4.

Some of the objectives for introducing this tax, which is a combination of gift tax and death duty, in Nigeria appear to be similar to some of the objectives for introducing it in the United Kingdom in 1974. This is because it has been claimed that "the object of CTT is to reduce large individual holdings of wealth in the United Kingdom".[34]; it is also for "the redistribution of wealth as a means to greater justice and equality in our society".[35] The similarity is not suprising since "as usual the Decree is patterned after the United Kingdom law".[36]

It is believed that the social and economic considerations which motivated the promulgation of the Decree are laudable and that the Decree may have a far-reaching effect towards achieving the declared objective. This is particularly so if the provisions of the Decree are faithfully and efficiently implemented both by the tax-payers themselves and by the already over-worked staff of our various Revenue Departments.

However commendable the objectives may appear to be when examined in isolation, some of them are self-defeating when looked at in collectivity. For instance, while in one breath the Decree tends to encourage youths to remain self-sufficient through the process of working hard for a living and having some ambition, in another breath it tends to impose some control in the acquisition of personal wealth and fortune. How far does labouring towards self-sufficiency go before the imposition of the control sets in? It amounts to blowing hot and cold to require a person to work hard for his economic independence and at the same time requiring him to stop at some point in that pursuit.

One of the reasons for this control is to avoid future disaffection and social explosion since according to the Head of State, "self-interest is undeniably part of human nature but so is envy".[37] If everyone becomes self-sufficient by working hard, then the issue of envy and disaffection will not arise. The reference to envy and disaffection imports some degree of economic equality through some elements of socialism. But his has no validity in a capitalist set up. It has been emphasized that "we cannot impose socialist norms and dogma . . . on an essentially capitalist institution without ensuring that the ethos and core values are redefined and the institution redesigned to serve the new values".[38]

Furthermore, the issue of control of acquisition of personal wealth is in conflict with the objective of using the tax as a source of revenue for the government. The idea of restraining such acquisition has an inherent disincentive effect. The government will not therefore try to discourage one of its possible sources for financing its economic and social programmes.

One of the criticisms of taxing marginal incomes heavily is its disincentive effect to work. Therefore if CTT bites seriously into a personal wealth such that hard work and enterprise is discouraged, it countervails some of the well-conceived intentions of the Decree. In particular, it will be a counter-offensive to the belief that every individual should work for his or her livelihood and that in doing so the individual inevitably contributes to the growth and development of the society. Although excessive wealth ought to be taxed, CTT should not be used as a vehicle for restricting the acquisition of personal wealth and fortune.

CTT must not be considered in isolation. It must be emphasized that there are other taxes such as income tax, capital gains tax and corporation tax, which together with CTT may affect the same persons who are supposedly well-to-do. Apart from the fact that the tax-payers may be suspicious of the multiplicity of the taxes, the government should not create a situation where a taxpayer's financial security will be endangered by his desire to minimise tax liabilities. Therefore CTT should be regarded more as a means of wealth redistribution rather than as a means of raising revenue. This appears to be the conception in Britain because, according to Ind, "the tax is not presented by Parliament as a revenue-raising measure but as a social measure with the objective of redistributing wealth. . . although a man should be allowed to accumulate wealth created by his own energies during his lifetime, that same wealth should not be too readily transferable to his children".[39] The principal "raison d'être" of CTT should be viewed from this perspective.

It is doubtful whether CTT per se can in fact, in all cases, curb the tendency among youths to regard the material successes of their parents as reasons for not wanting to make any effort to improve themselves and earn their own living. If a substantial amount of wealth is bequeathed to a son by his father, CTT can make only such a little dent on the whole bequest that the son who so desires can conveniently rely on it without further improving himself. The desire to improve oneself and have one's own ambition is more a factor of the social and political set up and self-discipline rather than of CTT.

## VI. SHORTCOMINGS OF THE DECREE

Since one of the objectives of the Decree is for the tax to serve as a revenue-yielding source, the fact that all property within the federation is not aggregated en bloc reduces the yield from the tax. The yield from this source could have been more substantial for financing our economic and social programmes if the aggregation were on national level rather than on piecemeal State levels. However, the problem of aggregation on a nation-wide level is to determine which of the States will be responsible for the overall aggregation and how the tax yield will be distributed among the States having regard to such exemptions as the first ₦100,000 and the family house and also the debts to be paid out of the various properties.

34. Ronald C. Ind. *Capital Transfer Tax* (Great Britain: Macdonald and Evans, 1977), p. 21.
35. R.J. Clements, "Capital Transfer Tax: Planning for the individual", *Journal of the Institute of Bankers*, Vol. 97, Part I, February, 1976, pp. 25-27.
36. C. Njokanma, *Capital Transfer Tax Handbook* (Enugu, 1980) p. 1 (unpublished).
37. *New Nigerian*, Op cit., p. IV.
38. Pius N. Okigbo, "The Capital Market and the Nigerian Economy", *Management in Nigeria*, Vol. 16, No. 3, March, 1980, pp. 8-13.
39. Ronald C. Ind, Op. cit., p. 278.

Also for the purposes of aggregation it is not clear from the Decree how property located outside Nigeria as well as shares and other such investments should be treated. For example, is the location of shares to be based on where the share certificate is deposited or where the register of shareholders is maintained?

The Decree provides that the value of any proprty for CTT shall be estimated to be the price such property would fetch if sold in the open market at that time. This may be fraught with difficulties. For instance, a market may not exist for that property, or where it exists it may not be perfectly competitive. Besides, a quoted price for a property is strictly comparable with another only if the grade, quality, location, delivery terms, credit terms, and auxiliary services are exactly the same. Some isolated prices represent nothing but distress prices for quick disposition of property in a financial emergency. Again there is the possibility that the property cannot be sold, or can only be sold to restricted persons, or can only be sold at a fixed price. Also, the Decree does not provide for the costs of the realisation of the property. It is for the High Court to determine the issue of the open market valuation when a case goes on appeal. The following observations of Swinfen Eady, L.J. on the same issue in the English case of *Commissioners of Inland Revenue v. Clay* [40] may be persuasive:

"A value, ascertained by reference to the amount obtainable in an open market, shows an intention to include every possible purchaser. The market is to be the open market, as distinguished from an offer to a limited class only, such as the members of the family. The market is not necessarily an auction sale. The section means such amount as the land might be expected to realize if offered under conditions enabling every person desirous of purchasing to come in and make an offer, and if proper steps were taken to advertise the property and let all likely purchasers know that the land is in the market for sale.... Not only is the probable buyer a competitor in the market, but other persons, such as property brokers, compete in the market for what they know another person wants, with a view to a resale to him at an enhanced price, so as to realize a profit."

As reasonably persuasive as these explanations are, they are difficult conditions to fulfill.

In determining the value of the state of a deceased person an allowance shall be made, inter alia, for reasonable funeral expenses which include reasonable expenditure in embalming and transporting the deceased to the burying place. However the Decee went beyond the requirement of reasonableness to put the ceiling of such admissible expenses at ₦1,000 in respect of a tombstone and ₦3,000 in respect of all other expenses. The restrictions completely ignored two important things which have remained with us, namely: the inflation and the differences in the status and place of the deceased. The Decree could have stopped short at the requirement of reasonableness which ought to vary with time and status of the deceased. Also the Decree does not provide for the apportionment of funeral expenses where the assets are located in more than one State.

Although the CTT is a combination of gift tax and death duty, some form of the latter is not new in Nigeria. There are the Administrator-General's Laws [41] which apply to an estate of a deceased person in respect of which probate or letters of administration may be granted by the High Court. Under these Laws, the Administrator-General may be appointed the sole executor of a will, and in some circumstances a person who establishes his claim may be granted probate of the will or letters of administration. One of the duties of the Administrator-General under this Law is to dispose of the property of the estate in the prescribed manner [42] which includes payment to the credit of the Consolidated Revenue Fund such percentage [43] as may be prescribed of the gross amount of money arising from the realization of the estate. This represents the duty on the estate of the deceased person. Since this duty could be readily avoidable by the simple device of transferring property inter vivos so as to reduce the taxable estate at death, the CTT has a more far-reaching effect.

One could have thought that like our predecessor, the United Kingdom, the CTT Decree which operates throughout Nigeria could have specifically repealed all the previous estate duty legislations. "The introduction of a far-reaching CTT [i.e. U.K. Finance Act 1979] removed the need to retain the long-standing estate duty liability and no liability for this duty will arise in respect of deaths occurring on or after March 13, 1975". [44] On the contrary, the Decree does not repeal or amend the Administrator-General's Laws and Ordinance, and one is left with the problem of determining their relationship with the Decree.

However, Section 20(4) provides that, where after filling the CTT Form by the person prima facie responsible for accounting for the tax, the Revenue shall, if satisfied with the information disclosed therein that CTT is payable in respect of any estate, issue a certificate of provisional assessment to him for the purposes [45] only of exempting him, if he applies to any court for probate or letters of administration in respect of the will or estate of, or of any matter connected with the distribution of the estate of, a deceased person, from payment of such fees as may be prescribed by any law including rules of court. It is further provided that such certificate shall not relieve any such person from payment of court fees chargeable for oaths or, subject to the Decree, of any probate fees where it is subsequently revealed that the estate is not chargeable to CTT.

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40. (1914), 3KB 466, 475.
41. See, for example, Administrator-General's Law (Eastern Nigeria) 1963 — Cap 4; Adminsitrator-General's Law (Western Region of Nigeria) 1959 — Cap 2; and Administrator-General's Ordinance (Federation of Nigeria and Lagos) 1958 — Cap. 4.
42. See Sec. 37 of Eastern Nigeria Law; Sec 35 of Western Region Law and Sec. 39 of Federal Ordinance.
43. The schedule of fees operating as per Eastern Nigeria Law representing percentage of value of assets collected under Sec. 16 or gross amount realized under Sec. 37(2) (b) is as follows:

| | |
|---|---|
| Not exceeding £100 | 4 percent |
| exceeding £100 but not exceeding £300 | 5 percent |
| exceeding £300 but not exceeding £800 | 6 percent |
| exceeding £800 | 7 percent |

(The schedule is subject to Sec. 55 of the Law)
44. K.R. Tingley, *Key to Capital Transfer Tax* (Second edition) (U.K.: Taxation Publishing Co.), p. 314.
45. See Sec. 25.

The implication of this, it would appear, is that both the CTT Decree and the Administrator-General's Law will operate pari passu. Where the value of the estate transferred on death exceeds ₦100,000 CTT will be imposed, but where it does not exceed ₦100,000 estate duty under the Administrator-General's Law will be payable. In the case of transfer inter vivos, however, any property whose value is not greater than ₦100,000 stands exempt from both taxes since transfer inter vivos does not come under the Adminstrator-General's Law. Being federal legislation, it is expected that in the case of any conflict the Decree would take precedence over the estate duty laws.

However, it would have been better if, as in the U.K., the estate duty legislation gave way to the CTT Decree for the sake of tidiness and unification and for the elimination of any doubts and possible confusion. The Decree could, where necessary, incorporate any portions of the Administrator-General's Law and similar laws which should be saved. Moreover, some aspects of the Administrator-General's Law, for example the rates of estate duty, are, in the light of current changes, out of alignment with some provisions of the Decree.

## VII. SUMMARY

Although efforts have been made to highlight the principal issues involved in our Capital Transfer Tax Decree, there are a few obscure points which were deliberately left out. As a new piece of legislation some time is needed to put it in practice before a meaningful stock is taken. Until it is fully understood and practised, its merits, pitfalls as well as ways of mitigating the tax cannot be fully appreciated. However, the introduction of CTT is another landmark in the development of taxation in Nigeria.

# Romania: Law of Finance

## Amended Juridical Framework of Financial Relations

by Drd. Ioan Condor *

Contents



### 1. The necessity of amending the financial mechanism and the legal framework therefor.

At the present time in the multilevel development of the entire national economy, based on the Program of the Romanian Communist Party,[1] as changes in society rapidly occur, the constant perfection of economic and financial management and planning and improved efficiency in all fields of activity become imperative. From the point of view of the Romanian Communist Party, the forms and methods of management, far from being immutable, must constantly be subject to improvement and adapted to the pace of development of economic and social life and at the same time to the objective requirements for the material and spiritual development of society.

In accordance with these facts and with exacting demands as to the quality of the management process as well as great openness to new elements, the Romanian Communist Party acted, and is still acting, to eliminate everything which had become superannuated and which no longer corresponds to the targets necessitated by rapid progress in constructing the socialist society to improve permanently the management and planning of the entire socio-economic sphere. Decisive moments in this framework for drawing up the socio-economic development strategy for the country were the measures taken by the Romanian Communist Party at the 9th Congress and the National Conference of 1967, the 10th and 11th Congresses and the National Conferences of 1972 and 1977 on perfecting socio-economic management and planning.

In conformity with the requirements of the present stage of development of the national economy, the Plenum of the Central Committee of the Romanian Communist Party,[2] which met on 22 and 23 March 1978, made decisions of exceptional importance on economic and financial management and planning, the raising of workers' self-management to a higher level, and increasing role and responsibility of each separate work collectivity (party) in the administration, with the goals of the most efficient utilization by the party of the national experts involved in the sphere of management, and of reinforcing economic-financial self-management. The entire process of elaborating the Party's documents and the laws of the country, intended to lead to the perfection of the economic-financial mechanism, has been directly led by President Nicolae Ceausescu, Secretary-General of the Romanian Communist Party.

The measures taken by the Plenum of the Central Committee of the Romanian Communist Party of 22-23 March 1978 are intended to increase the role of the financial-banking system which, while ensuring the financial means necessary to the progress of economic activity under the proper conditions, must pay more attention to the adequate use of these funds to encourage increasing economic efficiency. At the same time, the financial-banking system has to ensure permanent systematic financial control in all sectors of the economy in order to intervene promptly in settling the various matters which arise in the multilevel progress of our economy.[3]

With a view to implementing the measures decided upon by the Party on the further perfecting of financial and banking activity and the reinforcing of the role of finance to create better conditions for achieving the financial, monetary and foreign currency policies, the proper adjustment of the existing legal framework appeared to be necessary.

The Finance Law (No. 9 of 1972) which entered into force on 1 January 1973 was responsive to the goals set up by the 10th Congress of the Party and the National Conference of the Party of July 1972:

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1. Program of the Romanian Communist Party for creating a multilevel developed socialist society and Romania's advancing to communism. Politic Publishing House, Bucharest, 1975, pages 110-111.
2. Decision of the Central Committee of the Romanian Communist Party on the improvement of self-management and economic-financial planning, published in Official Bulletin No. 28 of April 8, 1978(I).
3. Speech at the Plenum of the Central Committee of the Romanian Communist Party, March 23, 1978 (Politic Publishing House, Bucharest, 1978), page 10.

 

- to raise to a higher level the planning, management and organization of the economy; and
- to ensure, within this framework, the improvement of economic-financial activity.

Coherently dealing with socialist financial matters at both a macro- and micro-economic level, the Finance Law was unique, not only nationally but also on the international scene. [4]

The decisions of the 11th Congress of the Romanian Communist Party, the National Conference of 1977 and the Plenum of the Central Committee of the Romanian Communist Party 22-23 March 1978, taken together with the requirements of the present stage of development of the national economy, call for the further improvement of the juridical framework of financial relations in order to reflect the measures adopted to perfect economic and financial management and planning.

To this end, the Great National Assembly has adopted the Law Amending and Completing the Finance Law (No. 9 of 1972). [5]

The measures adopted to perfect economic and financial management and planning are reflected also in the fiscal law field. Thus, as of January 1, 1979, provisions relating to the contribution to society of a part of the net production value (the so-called "prelevarea pentru societate a unei părţi din valoarea producţiei nete") became effective (Decree No. 429/1978). [6]

## 2. The system of monetary funds within the national economy

To best determine the proportions and pace of economic growth, one must consider the role played by proper distribution of the national income between development and the consumption fund. [7] With this in view, the Law has enacted many and various improvements which significantly fill out the provisions referring to the functioning of monetary funds in the national economy, thus creating a highly perfected legal system for the formation and distribution of these monetary funds.

The national income serves as a basic source of monetary funds in the economy and is distributed between a fund for consumption and a national fund for the socio-economic development of the country. The latter, however, is also funded through the depreciation fund as well as other sources.

*The national fund for socio-economic development* functions as an overarching fund system, comprised of a central fund for socio-economic development, a local fund for socio-economic development, the own funds for socio-economic development belonging to the State economic units, the own funds for socio-economic development set up by co-operatives as well as by other public organizations, [8] and the funds used by the people for building houses, production and raising of livestock, and other similar purposes.

From a material point of view, the national fund for socio-economic development is intended to finance new investments and the growth of material stocks out of it.

The means contained in the *fund for consumption* are remitted — in monetary form — to the working people through several channels, i.e. as a remuneration (according to the quantity, quality and social importance of the work performed), as profit sharing and as social retributions from the state budget or from the funds of the socialist units.

The Law reserves an important place and ensures a complete control to *the own funds* [9] of state economic units, cooperatives and other public organizations. Within the framework of measures adopted by the Romanian Communist Party, the concept of economic management has been enriched, amplified and given new qualities, as the enterprises must now cover their expenses from their own income, reimburse the amounts provided by society, ensure the self-financing of their own growth, provide material incentives for the working people and, at the same time, participate efficiently in the formation of the centralized resources of the state which are earmarked for certain objects and activities.

The material forms in which the enterprises hold part of the financial resources for self-financing of development and for creating incentives for the working people, as well as the conditions on which depend the amount of the resources held, both constitute component parts of the economic-financial mechanism and reflect, as regards the content and manner of functioning of the system of the monetary funds belonging to the economic units, the principal framework which was approved by the Plenum of the Central Committee of the Romanian Communist Party of 22-23 March 1978.

The amendments and completions to the Law of Finance effected by Law No. 2 of 1979 elaborate the measures by which these funds are legislatively instituted. The resources for the own funds of which state enterprises

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4. Iulian Vacărel, Law of Finance, a favourable framework for the increase of economic efficiency, enforcement of order and discipline in all fields of activity (Finance and Credit Revue No. 1/1973, page 4).
5. Law No. 2 of July 6, 1979, published in the Official Bulletin No. 59 of July 13, 1979.
6. This tax is a new form of profits tax which, in the case of realization according to plan, taxes away a portion of the net production value which is not needed by the entreprise. In the case of plan overfulfillment, a part of the incremental production value is to be returned to society in the form of a higher tax, due to the increased tax base, similarly in the case of plan underfulfillment, the tax will be reduced.
7. Constantin Iuga, Perfecting of the financial relations in the conditions of the new economic mechanism (Socialist Era No. 14 of July 20, 1979, pages 18-21).
8. The concept of "*socialist units*" comprises: the State economic units (enterprises and industrial centrals-enterprises association), state institutions (establishments), ministries and the other central and local bodies, agricultural, handicraft and consumption co-operatives and other public organizations. These socialist units are, in general, *economic units*, except the State institutions, ministries and the other central and local bodies and, sometimes, other public organizations.
9. M. Meheninţu, Enterprise funds, economic-financial self-management and its characteristic features (Economic Review No. 6 of February 9, 1979, pages 24-25); T. Stolojan, Monetary funds system belonging to the economic units (Accounting Review No. 1, 1979, pages 9-16).

can dispose are constituted from profits,[10] the depreciation of capital goods[11] and other sources established by law.

In order to enable the self-financing of their own development (i.e. financing from their own resources), the state enterprises can use the fund for economic development and the working means fund. The industrial "trusts" (associations of enterprises) may call upon the fund for the financing of investments in new enterprises and for the financing of important developments as well as the reserve fund for working means.

What is of paramount importance in the new regulations on self-financing is the basic principle that, from their funds, the enterprises must ensure the coverage of planned investments, the payment of installments due on the bank credits granted for investments, the planned annual growth of working means and the installments to be paid back to the state budget from the amounts received by new enterprises to cover their needs of working means in their first year of activity. Thus, only the financing of investments in new enterprises and important developments in existing enterprises, as provided for by the national one-time plan[12] (Appendix No. 1 of the Law), is ensured from the fund which has been set up for such a goal by a "Central".

In order to increase the role of the enterprises in satisfying social needs and to provide incentives for the working people to increase profits, provision is made for the establishment of a fund for housing construction and other investments with a social character, a fund for profit sharing of the working people and a fund for social activities. In addition to these funds, the enterprises may set up — based on production expenses — as own funds: a fund for scientific research, technological development and introduction of technical progress, a fund for labor protection and other funds provided for by law.

Provision is also made for the obligation of the enterprise to repay the funds received from society for financing their investment as well as the funds received for covering the necessary working means to the new enterprises during the first year of operation. For such new enterprises, the obligation to repay the amount received for financing the investment begins in the year following that in which the project begins operations.

There are also new and specific regulations with regard to the funds of the agricultural, handicraft and consumption co-operatives and also funds of other public organizations.

In this way a uniform, clear and precise legal framework is ensured for the own funds of the socialist units, which facilitates a better knowledge, application and control of their means of formation, distribution and utilization.

## 3. Income and expenses budget

The main instrument implementing the measures which aim at perfecting the economic-financial mechanism — in the financial field — is represented by the income and expenses budget. In this context Finance Law No. 9 of 1972 (amended by Law No. 2 of 1979) provides for financial activities on all organizational levels of the economy to be set up and developed on the basis of an income and expenses budget as well as other financial plans, all comprising a uniform system. This system of financial plans which has been brought to fruition by the new law comprises: the income and expenses budget; the state budget; the cash plan; the credit plans; the balance of income and expenses of the population, the foreign payments balance; the centralized financial plan; the territorial financial plans of the counties and the municipality of Bucharest.

In comparison to the previous regulation, new elements of the Finance Law regarding the system of financial plans include the income and expenses budget, the foreign payments balance and the territorial financial plans of the counties and the municipality of Bucharest. In this way, a complete schedule of financial plans, each of which is separately defined in the Finance Law, has been accomplished, thus ensuring a legal delimitation of the contents of each of the plans.

The *income and expenses budget*[13] has a central place and a special importance in the economic-financial activity of the state enterprises. The introduction thereof in all state enterprises and "industrial centrals"

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10. Law No. 29/1978 on the forming, planning, destination and payment of profits, published in the Official Bulletin, I, No. 114 of December 27, 1978. The law is also intended to apply the measures established to perfect management and economic and financial planning. In accordance with the law, which entered into force on January 1, 1979, "profit" refers to that portion of the newly earned profits generated by an enterprise's business activities which remains after deduction of the tax discussed in note 6, wages paid to the employees and other similar payments, research costs, including the costs for the introduction of new techniques, the tax on total remuneration fund, contribution to social insurance and any other cost connected with the labor force. The anticipated profits for enterprises are planned in advance on the basis of efficiency indicators and standards prescribed by law, and are then set forth in the enterprise's income and costs budget. The planned profits of the State economic unit are applied to returning the funds received from society, to form own funds in order to replenish or expand its own supply of funds and in payment of any outside obligations as provided by law. The sums remaining subsequent to such distributions represent payments to the State budget. In the event that an economic unit generates profits in excess of the planned profit level, the law requires that at least 35 percent of the excess amount must be paid to the State budget. The exact amount which must be paid is determined taking into account the relevant legal provisions concerning the allocation of over-planned profits either to an enterprise's own funds or in satisfaction of outside obligations. If the State economic unit is not successful in achieving its planned profit level, then it is only required to pay into the State budget the amount of profits it actually achieved.
11. Law No. 62/1968 on the capital goods redemption, republished in the Official Bulletin No. 6-7 of January 19, 1977.
12. The national unic (single) plan for economic and social development can be — in the Romanian legal system — an annual (yearly) or five year plan.
13. Gh. Boulescu, Income and expenses budgets, instruments of management of the economic-financial activity (Accounting Reveiw No. 10/1978, pages 1-5); Gh. Vîlcu, Income and expenses budget for the state establishments (Accounting Review No. 4/1979, pages 1-9); A. Bran, Income and expenses budget of the economic units (Economic Review No. 23/June 8, 1979, pages 10-11); A. Sesan, Economic-financial self-management (Scînteia No. 10222 of Sept. 20, 1978).

occurred during the second half of 1978, under the terms of the previous legislation.

This budget has been conceived as a basic instrument of the managing bodies in enterprises, "industrial centrals", establishments, ministries and the other central and local bodies for the planning of economic-financial activity, with the aim of ensuring the achievement of the targets of the economic and financial plans and guaranteeing the financial balance.

In fact, the income and expenses budget is a basic instrument of the collective management of the State enterprises in reinforcing economic-financial self-management and self-financing, because it constitutes a synthesis, in monetary form, of the economic and social activity in every enterprise: it is a reflection of the conditions under which material and financial funds are managed and ultimately of the results obtained and the efficiency with which these results are obtained. Using these budgets, the general assemblies of the working people and the collective managing bodies of the enterprises are able to consider and set up measures to strengthen economic-financial self-management, the growth of economic efficiency and the degree of self-financing for their respective enterprises only.

At the same time, the income and expenses budgets are a useful tool in planning financial activity, used at the draft stage when proposals must be submitted for approval. The budget is drawn up by the collective managing body of the State enterprise on the basis of the proposals and is adopted by the general assembly of the workers.

Finally, these budgets are an instrument to analyze the implementation of financial activity and also the financial balance, for they can be used to take appropriate measures in fields where deficiencies or shortfalls in economic and financial proposals or infringements of planning and financial discipline appear.

The income and expenses budgets, at all levels, are conceived as part of an integrated system, in correlation with the national one-time plan, the state budget, the credit plans and the centralized state financial plan.

Measures to implement the perfected economic-financial mechanism are also relevant for the activity of the territorial administrative bodies and the state establishments. In this way emphasis has been placed on the fact that self-management and self-financing require that each territorial administrative body, each town, each commune, would have its own income and expenses budget. It is intended that, within a few years, all localities in the country will be able to finance themselves without expecting allowances from the state budget. [14] Thus, the income and expenses budget of the administrative territorial bodies becomes the main instrument through which the people's councils try to achieve more rapid development of the urban and rural communities.

The increased resources for the rise in the degree of self-financing are ensured by the increase in the income of the local budgets, because a close relationship exists between the socio-economic development of each administrative territorial body and the strengthening of its self-financing. Therefore, in addition to the introduction and application of a strict savings scheme so that the targets could be implemented with as reduced an amount as possible of material and financial aid, it seemed necessary to aim at further enlarging the income basis of each locality through the development of industrial activities relating to local needs for services, and handicrafts and other income-producing activities utilizing to the utmost local raw materials. [15]

## 4. Amended forms of financing and crediting the national economy

The measures taken to perfect the economic-financial system have also imposed new regulations in the fields of financing and granting credits for production, turnover and investments. An improvement can be seen in the system which established the level of the funds for the working means and the methods for covering them financially.

The working means fund is partially constituted from profits expressed as a rate of the yearly increase of the total working means and approved through the state budget. The other part of the increased need for working means is covered by bank credits. In the first year of activity, the financing of the needed working means of a new state enterprise is guaranteed from the state budget. In succeeding years the financing of the working means is secured from the working means funds and other resources which are temporarily available, according to law.

Financing and crediting of investment projects which have been approved through the national one-time plan for economic and social development are provided for as follows:

- investments in new enterprises and important expansions (detailed in Annex 1 to the Law) are financed from the fund established by the "industrial centrals" and, where this fund is insufficient, redistribution can be made within the same ministry; should the planned needs not be met, the difference is to be covered by allowances from the central fund for socio-economic development which is included in the state budget;
- investments in existing enterprises, except important expansions (mentioned in Annex 1 to the Law), are financed from the enterprise's own fund for economic development, supplemented by bank credits;
- house building and other investments with a social character are financed from an own fund which has been especially set up for this purpose by the enterprise, supplemented by bank credits;
- investments of the state establishments are financed from the state budget.

14. Nicolae Ceausescu, Speech at the Conference of presidents of the people's councils, 29-31 March 1978 (Politic Publishing House, Bucharest 1978, page 20).

15. I. Condor, L. Varlam, Forms of material incentives applied in the field of local budgets (Economic Review, supplement No. 28 of July 13, 1979, pages 10-11); I. Pătrascu, Self-financing, incentive in development of localities (România Libera of January 9, 1979).

Through the means of financing and granting credits in the field of investment, emphasis is placed on the stimulation of state enterprises to provide themselves with sufficient resources and to finance the investments first out of their own funds.

Funds which the enterprises have received for financing investments and covering the need for working means in the first year of activity are to be repaid out of the redemption of capital investments as well as out of profits.

The Law provides an important explanation for the jurisdictional character of the credit. It provides for credit relations between banks and economic units to be established on a contract basis containing: the amount of credits to be granted, the terms for the granting and reimbursing of the credits, the interest rate and the obligations and responsibilities of the contracting parties.

Of particular importance are the provisions regarding the measures for economic-financial recovery which are established by law in order to strengthen discipline in the management of material and financial means for those economic units which are not fulfilling their plan targets, are immobilizing the working means and are unable to reimburse within the time limit the credits received. These measures are essentially the following:

— setting up of bank control on payments which have been due for more then 60 days, the financing bank having the right to refuse to effect those payments which breach the legal rules related to reasonable management of material and financial means, planning and financial discipline and to introduce an instrument of payment based on the prior liquidity of the enterprise. At the same time, the banks are obligated, together with the next-highest ranking body of the concerned unit, to examine the economic-financial condition of the enterprise and to propose or even establish measures intended to lead to the recovery of the activity;

— examination of the economic-financial situation of those units whose working means are frequently immobilized and which are unable to reimburse on time the credits received. The examination is to be made by the bank, together with the managing bodies of the respective enterprises, "industrial centrals", ministries and other central or local bodies, with the assistance of the State Committee of Planning, Ministry of Finance, Ministry of Technical Material Supply and Capital Goods Management Control, Ministry of Foreign Trade and International Economic Co-operation. On the basis of the examination and subsequent debate in the general assembly of the working people from the respective enterprises, effective measures are set up in order to restore a sound economic-financial situation. The means for achieving the established measures are controlled by the Ministry of Finance together with the Central Board of Workers Control of Economic and Social Activity and the Superior Court of Financial Control;

— establishment of a special regime of economic-financial supervision, set up for those economic units which continue to be unable to make payments despite the measures taken, or which incur losses or seriously breach the rules of fund management. The setting up of this regime is intended to take measures aiming at the profitability and recovery of the enterprise's economic-financial activity, and to establish the reasons for such unprofitable activity and the responsibilities of the persons in charge of the management of the enterprise. The special regime is set up by the Council of Ministers, on the proposal of the Central Board of Workers Control of Economic and Social Activity, the Superior Court of Financial Control and the Ministry of Finance. During the period established by the Council of Ministers for this special regime, an economic-financial supervisory board is constituted which must analyse the reasons for the unprofitability of the enterprise and establish compulsory measures to restore economic-financial soundness, which proposals are subsequently debated in the general assembly of working people. The responsibility for the recovery of economic-financial soundness lies by law with the working people's board together with the economic-financial supervisory board. Should it appear that the condition of the economic unit is a result of the actions of the manager or another person of the unit leadership, the supervisory board can propose the dismissal of such individuals and forbid them assuming further managerial positions for a limited period.

### 5. Provisions referring to financial-foreign exchange relations

A new Chapter (V) was introduced by Law No. 2 of 1979 which, for the first time in the framework of the Finance Law, governs financial-foreign exchange relations.

The Law establishes *the uniform system of plans*, which forms the basis for the functioning of financial-foreign exchange activity and which is comprised of: the balance of foreign payments, the plan of payments and receivables in foreign currency of enterprises, "industrial centrals", ministries and other central and local bodies and the balance of foreign rights and liabilities.

The *balance of foreign exchange* [16] is drawn up by the Ministry of Finance, the State Committee of Planning, the Ministry of Foreign Trade and International Economic Co-operation and the banks together with the ministries and other governmental bodies, keeping in mind the indicators of the national plan and the state budget and the need for an even balance in foreign exchange. It is submitted to the Council of Ministers and approved simultaneously with the national one-time plan for socio-economic development, annual or five-year.

Law No. 2 of 1979 introduces, for the first time, such a plan for *foreign exchange receipts and payments of enterprises, "industrial centrals" and ministries.* This

16. C.C. Kiritescu, International currency-financial relations (Scientific encyclopedia Publishing House, Bucharest 1978, page 170); I. Bituleanu, The trade balance and its role in economy (România Libera No. 10742 of May 11, 1979).

plan encompasses the total of foreign exchange receipts and payments, drawn up in conjunction with the economic and financial plan and the balance of foreign payments situation.

The economic units and central bodies are authorized to engage in importation and to make payments within the limits of the provisions of the plan, dependent upon the availability of foreign exchange resources from exports. In cases where export receipts do not meet the quota established in the quarterly plan approved for the ministries and such a condition affects the planned foreign exchange balance, the ministries involved cannot contract new imports within the limits of the unfulfilled receipt amounts. At the same time, the central bodies are obligated to report to the Council of Ministers on the measures taken in order to meet the receipts and ensure the planned foreign exchange balance.

*The balance of foreign receipts and liabilities* [17] is drawn up by the Ministry of Finance, the State Committee of Planning, the Ministry of Foreign Trade and International Economic Cooperation and the banks. It is submitted to the Council of Ministers at the same time with the yearly and five-year plans.

The socialist entities, from the enterprises up to the ministries and banks, keep records in both foreign and domestic currency of the receipts and liabilities resulting from foreign trade and other foreign activities and are responsible for collecting receivables in foreign currency and for payments of debts engaged abroad, and for periodically reporting their position to the Ministry of Finance.

The basic legal regulation of foreign credits and payments is also established by the Finance Law. In this way, provision is made for setting up foreign credit relations on the basis of foreign contracts, agreements, conventions and other understandings. Foreign credits are granted and received through banks, foreign trade enterprises and other authorized bodies. There are also regulations for those financial resources from which foreign credits are granted and for obligations of economic units which engage in foreign trade and of banks with regard to the performance of credit transactions abroad, as well as their obligation to keep records thereof and to make proper provisions in the foreign contracts in order to ensure receipt of the rights to which they are entitled and to fulfil due procedure to collect all rights and obtain the due amount. At the same time, the Finance Law established the duties of the central bodies and those of the economic and financial central synthesis bodies charged with collecting by the due date the rights resulting from the granted credits and also the repayments due on credits received.

Law No. 2 of 1979 has added to the Finance Law (No. 9/1972) rules with regard to the financing and crediting of foreign trade and regulations as to the crediting of Romanian economic units which participate in joint ventures.

We can therefore see that this new chapter of the Finance Law, which is justified by the unprecedented upward trend of foreign trade and international economic co-operation of Romania, is made up of the major regulations which form the general legal framework of financial-foreign exchange relations. This is necessary because Romania's growing participation in world-wide economic trade imposes the necessity of perfecting the national monetary system and financial-foreign exchange and credit relations, in the light of the close inter-influence among international economic co-operation, foreign exchange relations and finances.

## 6. Conclusion

In implementing the measures taken to perfect the economic-financial mechanism, encompassed in the amendments made to the Finance Law, the enlarged role, duties and responsibilities of all state units in strengthening the workers' self-management, economic-financial self-management and discipline in handling financial funds is ensured.

These same ameliorated provisions of the Finance Law also ensure the enlarged role, duties and responsibilities of the Ministry of Finance and the banks in working out and implementing the national one-time plan, the state budget, the centralized Financial plan, the foreign payments balance, the plans of receipts and payments in foreign currency, the balance of receipts and liabilities abroad, and other plans, and also ensure obtaining peak efficiency in the conditions necessary to maintain a general economic and financial balance, and prompt and firm action in solving economic-financial problems. In the same way, the duties and responsibilities of financial accounting departments have increased as have those of the staff charged with the task of exercising financial control from the outset which must both observe planning, contractual and financial discipline.

17. The balance comprises the rights and obligations towards foreign countries, at a certain moment, from export, import and international economic co-operation activities, construction, services, tourism and other activities, as well as the external credits received and allowed, related interest and fees, participants in joint ventures and international financial-banking bodies, liquidity in foreign currency abroad and liquidity of foreign partners with Romanian banks and other rights and liabilities in foreign currency in foreign relations.

# Economic Development, Foreign Investment and Taxation in the Trust Territory of the Pacific Islands

by Elizabeth S. Udui*

CONTENTS



## I. INTRODUCTION

*The Trust Territory of the Pacific Islands includes virtually all (2,203) Micronesian islands in the North Western Pacific except the U.S. Territory of Guam, the Republic of Nauru, Tuvalu and Kiribati. Spread over a three million square mile expanse of water, these islands together amount to less than 720 square miles of land area.*

*The Trust Territory is administered by the United States under a Trusteeship Agreement with the United Nations. This agreement was never intended to be a permanent arrangement. In 1976, the Northern Marianas group became a Commonwealth of the United States. The other three entities, the Federated States of Micronesia (comprised of Kosrae, Yap, Truk and Ponape States), the Marshall Islands and Palau will have separate constitutional governments and will sign future agreements with the United States, scheduled for 1981.*

*Major commodity exports include coconut oil, copra cake, frozen tuna fish, copra, and handicraft. The entities also receive "invisible exports" from tourism and the sale of fishing rights within their 200-mile economic zones to foreign fishing companies.*

*The Northern Marianas, as a Commonwealth of the United States, will follow the United States tax system and will be excluded from this discussion. For the moment the three remaining entities of Micronesia have a relatively simple tax system based on gross receipts and gross wages with no deductions. The tax burden is low. In 1978, for example, only about 4 percent of the more then $138 million in grants and revenues to the Trust Territory Government was made up of local tax revenues. So far, Palau has been the only area in which export incentive tax measures have been passed.*

## II. ECONOMY

The Micronesian economy is based primarily on Government employment and services arising therefrom. In the private sector, it depends on agriculture, fishing and tourism. Similar to other developing areas its rural population derives its primary income from subsistence activities.

Estimates based on the 1973 Census of Population indicate that the population of Micronesia in 1980 is about 121,000, of which about 70 percent live on or near the six administrative centers.

There are 16,500 people employed for wages; average wage is US$3,412. The average government wage is about 1.5 times the average private sector wage. Average per capita income is $820.

Micronesia has an overall deficit in its balance of trade, which varies from entity to entity. Palau, with more

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than 60 percent of all exports, has a favorable trade balance. Government imports are not taken into account in these calculations.

There are about $18 million worth of aggregate assets of foreign investment in Micronesia. Of this, more than half is in Palau in a coconut oil plant, tuna freezing plant, POL distribution center and hotel.

U.S. currency is used; U.S. postal services and branches of U.S. banks are in all administrative centers.

## III. INVESTMENT OPPORTUNIES AND PROCEDURES

Because of the overall dependency of the Territory on U.S. grants, the development of the private sector has been relatively limited. Nevertheless, there are investment opportunities in tourism, marine resources, agriculture and related industries.

### A. Tourism

Tourism offers the most immediate opportunities for expansion. Although tourist numbers are small (25,700 visitors during 1979), growth has averaged over 11 percent for the past five years. Major constraints to the development of tourism include hotels (there are only 367 rooms throughout the Territory) and airline seats. About 50 percent of visitors are from the United States and 25 percent from Japan. Over one third of all tourists visit Palau. Development of tourism is monitored carefully to protect the fragile island environments.

### B. Marine Resources

Micronesia's millions of miles of ocean and hundreds of square miles of fringing reef and lagoons present many opportunities for development. The offshore resources are presently being harvested by Japanese, Taiwanese and American fishing vessels under various agreements with local maritime authorities. The only local harvesting of the offshore tuna resources is done in Palau where between three and five thousand tons of skipjack are harvested annually and exported to canneries abroad.

### C. Agriculture

Agriculture is the largest productive sector of the economy, constituting the major activity of more than 50 percent of all households.

Commercial agriculture development will require intensive use of land, involving substantial capital investment and technology. Copra oil mills in Palau and the Marshalls are the major investments in agriculture-related business. Other areas with potential for development for production and processing include coconut products, staple crops, vegetable and fruit crops, black pepper, livestock and poultry (eggs).

### D. Procedures

1. *Foreign investment permits.* Permits to conduct business are issued in accordance with the Foreign Investors Business Permit Act. Under this law, applications from foreign investors are reveiwed by foreign investment boards in the various states prior to approval or disapproval by Chief Executives. Further information on this procedure may be obtained from foreign investment boards in Palau and the Marshalls and from the Director of the Department of Resources and Development of the Federated States of Micronesia.

2. *Work permits.* Import of alien labor is regulated by the Protection of Resident Workers Act. Under this law, alien workers may be granted one year work permits after it has been determined that no local person is available with requisite skills.

3. *Corporations and partnerships.* Corporations and partnerships may be chartered or registered with Registrars of Corporations in the Marshalls, Palau and Federated States of Micronesia.

4. *Licenses.* Other licensing requirements are in force in various localities and vary from state to state.

## IV. TAXES

Because of the present emergence of three separate entities (Marshalls, Palau and Federated States of Micronesia) in the Trust Territory, it is extremely difficult to discuss the tax administration of each separate entity and of states within entities. In general, tax laws derive from general taxing and licensing laws which were in force prior to the transfer of these functions to the new constitutional governments of Micronesia.

The following economic controls are generally held by the Marshalls, Palau and Federated States of Micronesia central governments.

### A. Economic controls and taxation authority

#### 1. Central governments

The Central Governments fulfill the following tasks:

(a) Control of banking, organization of business corporations, business associations, credit unions and cooperatives, insurance, sale of securities, and public utilities, including the exclusive licensing of such activities. Persons and companies engaged in these activities are subject to local general taxation, but not subject to any local licensing requirements or payment of license fees for these activities other than to the central government.

(b) Control of the establishment and operation of and investment in business and corporations by noncitizens.

(c) Establishment and control of the terms and conditions under which importing and exporting licences shall be issued.

(d) Exclusive control of import, export, and income taxes including any excise taxes which are actually collected on the basis of imports.

## 2. State governments

State governments are charged with:
(a) Liquor control, including the right to collect wholesale liquor license fees and to impose taxes on alcoholic beverages; however, neither of these shall be on imports or volume or value of imports.
(b) Exclusive issuance of licenses for wholesale business, other than banking, insurance, sale of securities, and public utilities, including the exclusive right to collect fees for such licenses, provided these are not based on imports or volume or value of imports.
(c) The imposition and collection of sales taxes, and the authorizing of municipalities to impose and collect excise taxes on any items other than foodstuffs.

## B. Taxes, levies, charges, duties, etc.

### 1. Import taxes

All entities levy taxes on certain goods imported into and exported from their jurisdictions and on the use, distribution, and sale of gasoline and diesel fuel within their jurisdictions.
(a) Cigarettes — seven cents per every 20 cigarettes;
(b) Tobacco, other than cigarettes — 50 percent ad valorem;
(c) Perfumery, cosmetics and toiletries, including cologne and other toilet waters, articles of perfumery, whether in sachets or otherwise, and all preparations used as applications to the hair or skin, lipsticks, pomades, powders and other toilet preparations not having medicinal properties — 25 percent ad valorem;
(d) Soft drinks and non-alcoholic beverages — at the rate of two cents on each 12 fluid ounces or fractional part thereof;
(e) Beer and malt beverages — at the rate of four cents per can or bottle of 12 fluid ounces or fractional part thereof;
(f) Distilled alcoholic beverages — at the rate of seven dollars per wine gallon, except that any person permitted by applicable law to possess, consume and use distilled alcoholic beverages may bring into such district/state of the Trust Territory tax free, an amount of liquor not to exceed two fifths of a wine gallon per trip, if such liquor is for his personal use and consumption and not for resale;
(g) Wine — at the rate of two dollars per wine gallon, except that this tax shall not apply to any religious organization which is importing or receiving into the Trust Territory sacramental wine for use in the religious rites of such organization;
(h) Foodstuffs for human consumption — one percent ad valorem;
(i) All other imported products, except those specified above and gasoline and diesel fuel — three percent ad valorem.

### 2. Export taxes

The following export taxes have been levied on all scrap metal exported from the various jurisdictions:
(a) Nonferrous — 25 percent ad valorem;
(b) Ferrous — five percent ad valorem;
(c) Lead and lead covered cable—ten percent ad valorem.

### 3. Gasoline and diesel fuel tax

An excise tax is levied upon the use, distribution or sale within the Trust Territory of all gasoline and diesel fuel at the rate of five cents per gallon so used, distributed or sold. The tax is paid by the importing company directly to the three entities.

### 4. Income tax

All entities impose a tax of five to ten percent upon the gross wages and salaries received by every employee, except that those employees whose gross annual wages and salaries are $5,000 or more are allowed a deduction of $1,000 per year from all wages and salaries subject to tax. Employee is generally defined as any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee.

### 5. Business tax

A forty dollar tax per year is levied upon that portion of the amount of gross revenues earned by every business which does not exceed $10,000 per year and an additional tax of 2.5 percent to 3 percent per year is levied upon that portion of the amount of gross revenues earned by every business which is in excess of $10,000 per year. Businesses which earn gross revenues of not more than $2,000 per year are exempted from taxation.

### 6. Meaning of income

Although taxable income in the ordinary sense excludes certain types of expenses, for Trust Territory entities' income tax purposes, income is divided into two major categories: gross wages and salaries of employees and gross revenue of businesses. The following is the statutory definition of income:

(a) *Wages* or *salaries* mean and include commissions, fees, compensation, emoluments, bonuses, and every and all other kinds of compensation paid for, credited or attributable to personal services performed by an individual, which services have been performed by such person as an employee. Wages and salaries shall not include the following:
— Wages and salaries received from the United States by members of the Military or Naval Forces of the United States or the Armed Forces of the United States.
— Reasonable per diem and travel allowances to the extent that they do not exceed any comparable Trust Territory Government rates.
— Rental value of a home furnished to any employee or a reasonable rental allowance paid to any employee (to the extent such allowance is used by the employee to rent or provide a home).
— Any payment on account of sickness or accident disability, any payment of medical or hospitalization expenses, made by an employer to or on behalf of an employee. Normal wages or salaries paid to an employee for a period of time during which he is excused from work because of sickness are not excluded from wages and salaries.
— Remuneration paid for casual or intermittent labor not performed in the ordinary course of the em-

ployer's trade or business and for not more than one week in each calendar month.
- Any payment in the form of a scholarship, fellowship, or stipend made to any employee while he is a full-time, bona fide student at an educational institution within the Trust Territory.
- Wages and salaries received by a minister of the gospel, or clergyman from a religious group or organization.
- Wages and salaries received by an employee for services performed or rendered in the capacity of a domestic or household employee for a private individual or family.
- Wages and salaries received by a non-Trust Territory citizen employee for services performed or rendered within the Trust Territory for a total of not more than 90 days or less during any one calendar year.

(b) *Gross revenue* means the gross receipts, cash or accrued, of the taxpayer received as compensation for personal services not in the form of salaries or wages and the gross receipts of the taxpayer derived from trade, business, commerce or sales and the value proceeding or accruing from the sale of tangible personal property, or service, or both, and all receipts, actual or accrued by reason of the capital of the business engaged in, including interest, discount, rentals, royalties, fees, or other emoluments however designated, and without any deductions on account of the cost of property sold, the cost of materials used, labor cost, taxes, royalties, interest or discount paid or any other expenses whatsoever.

*Gross revenue* does not include the following:
- refunds, rebates and returns;
- monies held in a fiduciary capacity;
- income in the form of wages and salaries which is taxed separately.

Income has also been administratively interpreted to include casual sales as follows:
- Sales made in performance of any profession, trade, manufacture or any other undertaking that requires different skills, materials and tools than those normally used in the conduct of the taxpayer's activity. Casual sales are limited to 12 individual transactions per calendar year and $2,000 in annual gross revenue.
- Casual sales include annual gross revenue of $200 or more from the sale of farm produce, fish or native handicraft.

## 7. Rules governing apportionment of income

(a) If an employee is credited or paid salaries or wages derived from, or attributable to, personal services performed or rendered both within and without the jurisdiction during any given month, then the whole of the salaries or wages is presumed to have been earned within the jurisdiction. The employer paying the tax or the employee whose compensation is taxed may file for an apportionment of the tax.

(b) If any business earns or derives its gross revenue from business activities or undertakings both within and without the jurisdiction during the taxable year, then the whole of its gross revenue is presumed to have been derived from sources within the jurisdiction. The business may file for an apportionment of the tax.

## 8. Ascertainment of income

The tax imposed is collected by the employer by withholding the appropriate tax from the employee's wages and salaries. The employer is liable for payment of the tax withheld on a quarterly basis. All taxes withheld by the employer are held in trust by such employer for the government. Employees whose taxes have been withheld by their employers do not file a return. Annual wage and tax statements and reconciliation of income tax withheld coupled with field audits serve as a basis for compliance. Any individual who is paid or credited wages or salaries from an employer who does not have a place of business in the Trust Territory and does not have an agent within the Trust Territory responsible for withholding the appropriate tax is required to file an individual return.

As a practical matter, all taxes may be passed on to consumers. However, specific notation on an invoice showing taxes as additional charges to consumers is misleading and such a practice has been administratively interpreted to be unlawful.

## 9. Ascertainment of income from businesses

*Business* means any profession, trade, manufacture or other undertaking carried on for pecuniary profit and includes all activities, whether personal, professional or incorporated, carried on within the Trust Territory of the Pacific Islands for economic benefit either direct or indirect, and excludes casual sales. One who qualifies as an employee is not considered as a business.

A business is exempted from tax if its gross revenue is $2,000 or less during any one tax year. Since the tax is on gross revenues or gross receipts the following receipts are not considered gross revenue:
- Refunds, rebates and returns.
- Monies held in a fiduciary capacity.
- Income in the form of wages and salaries which has been taxed under other provisions of the law.

Businesses are also exempted from taxation on revenues which are accrued but which subsequently are found to be uncollectible (bad debts). The amount of such bad debts will be allowed as a deduction only in the year in which it is determined to be uncollectible. The law does not allow deduction and exemption from taxation of business expenses such as directors' remuneration, management fees, rents, interest expense, travelling, accounting and consultancy expense, entertainment expense, and research.

The only item of pure income exempted specifically by law is income from copra production by unincorporated copra producers either collectively or severally. This was intended to encourage production and export of copra, a major income earner of a large proportion of those engaged in subsistence activities.

### 10. Tax treatment of special sources of income

Dividends, interest, technical service fees, management remuneration, film leasing, rents, etc. are taxed on their gross amount if they are attributable to the engagement of business capital or if they are connected with the carrying on of a business.

Again, the tax on businesses is on gross revenues as gross receipts. Rules governing ascertainment of profits, conditions of expenses and other deductions from gross revenue do not apply.

### 11. Treatment of losses

The tax on gross revenues does not allow deduction for losses sustained by a business except for bad debts which have been determined to be uncollectible; provided, however, that accrual of revenue was made for which the tax had been paid. Allowable losses incurred by a business arising out of change of ownership may be taken in the same manner as an additional tax liability.

Setting off refunds and additional tax liability may be made provided that the refunds and the additional tax liabilities have been determined using the appropriate tax rate in the year incurred or otherwise accrued. Carry forward or carry backward of losses is not provided for by law.

### 12. Tax treatment of corporate entities

Corporations are taxed at the same rate and in the same manner as any other business. For purposes of reporting, businesses are classified in three major categories:

(a) *Unincorporated "Unitary Business"*. A "unitary business" is one carrying on one kind of business of which the component parts are too closely connected and necessary to each other to justify division or separate consideration.

(b) *Unincorporated "non-unitary businesses"*. A "non-unitary" business is one which shows units of substantial separateness and completeness, each of which might be maintained as an independent business and be capable of producing profit in and of itself. Each unit is taxed as a separate business.

(c) *Incorporated businesses.* A corporation consisting of two or more separate and distinct businesses would pay the tax on the combined gross revenues of all the business as one entity.

### 13. Tax treatment of the family: head, wife, children and dependents

The tax on personal income is a tax on gross wages and salaries of an individual who qualifies as an employee. As the tax is on gross wages and salaries, the liability is determined on the basis of each individual employee and no regard is given as to dependents, head of household, spouse or any other kind of support which an individual taxpayer may provide for his family.

As the only income tax applicable within the Trust Territory is on wages and salaries, a tax liability exists only if an individual qualifies as an employee. There is no liability for wealth tax, gift tax or any other tax (with the exception of social security) as there is neither law nor statute imposing such taxes. Considerations relative to property ownership, property held by members of a family do not apply therefore.

### 14. Liability of non-citizens, non-residents (individuals and companies)

*Individuals.* Non-resident means any individual who received income from sources within the Trust Territory but does not reside or perform services within the Trust Territory for a period of 90 days or more during any one calendar year (tax year). Non-residents do not pay the tax but are required to file a return for ascertainment of status. Non-citizen means any individual who is not a citizen of the Trust Territory of the Pacific Islands and who performs services within the Trust Territory. Non-citizens are required to pay the Trust Territory income tax in the same manner as that required for citizens, except that the tax rates for non-citizens are limited to three percent if they are employees of the United States Government, agencies, instrumentalities thereof, and contractors if their purpose is not in the interest of the Government.

*Companies.* Non-resident company means a business activity which operates both within and without the Trust Territory and whose principal place of business is located outside the Trust Territory. Non-resident companies are taxed in the same manner as resident companies except that that tax rate is limited to one percent if they are contractors of the United States, United States agencies and instrumentalities; provided, however, that their activities are not in the interest of the Government.

### 15. Liability of partnerships and joint ventures to tax

The gross revenue tax applies to all businesses as defined, without regard to the business formation such as sole proprietorship, partnership, corporation, or joint venture. A partnership must file a return and pay the tax in the same manner as any other business.

### 16. Liability of foreign states, foreign state trading enterprise

Although it was not the intent to tax enterprise activities of other government units, agencies or instrumentalities, the tax would apply to a specific government enterprise only is such activity was determined to be carried on for pecuniary profit and is considered a non-essential government service.

### 17. Trusts

There are generally no trust companies established within the Trust Territory.

## V. DOUBLE TAXATION, EVASION, AVOIDANCE

### A. Double taxation

Foreign enterprises (non-resident companies) and permanent establishments (resident companies) are subject to tax only on that portion of income which is earned in or derived from sources or transactions or parts of transactions within the Trust Territory. This scheme eliminates double taxation on that portion of the revenue earned outside the Trust Territory. It is presumed that the same principle applies to other countries.

Although there is no statute in the Trust Territory governing the exchange of information with other countries, data and information of a general nature may be made available to other countries. Specific details pertaining to a particular taxpayer cannot be exchanged, however, except for the purpose of carrying into effect the tax law or any other enactment imposing taxes or duties payable to the governments. For the purpose of ascertaining the correctness of any return and determining the liability of any person for any income tax the particular government is authorized to:

- Examine any books, papers, records, or other data which may be relevant or material to such inquiry. The required records shall be made available no later than ten days beginning with the date that the request is received.
- Summon the person liable for tax or required to perform the act, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax or required to perform the act, or any other person the Director or his designee may deem proper, to appear before the Director or his delegate at the time and place named in the summons and to produce such books, papers, records, or other data, and to give such testimony, under oath, as may be relevant or material to such inquiry.
- Take such testimony of the person concerned, under oath, as may be relevant or material to such inquiry.

### B. Avoidance, evasion

The Trust Territory income tax law has the following provisions as anti-avoidance statute.

1. Assessment.

Upon the failure of any person, business, or employer to make and file a return required by law within the time and in the manner and form prescribed, or upon failure to pay any amount due, the Director may notify such person, business or employer of such failure and demand that a return be made and filed and the tax paid as required.

If such person, business or employer upon notice and demand by the Director fails or refuses within 30 days after receipt of said notice and demand to make and file a return and pay the tax required, the Director may make a return for such person, business or employer from any information and records obtainable, and may levy and assess the appropriate amount of tax. Such assessment shall be presumed to be correct unless and until it is proved incorrect by the person, business or employer disputing the amount of the assessment.

2. Records and audit.

All persons, employees, and businesses required to make and file returns shall keep and maintain accurate records, which may be inspected and audited at any reasonable time by the Director.

3. Criminal penalties.

Any person or business convicted for tax evasion shall be fined not more than $1,000, or (if a natural person) imprisoned for not more than one year, or both.

4. Separate civil penalties.

The criminal penalties imposed for violation of provisions of the law are separate from, and in addition to, all other penalties or interest. The following civil penalties are levied and may be assessed and collected.

(a) *Failure to file return on time.* If any taxpayer fails to make and file a required return on or before the date set, unless prior to that date such taxpayer applied for and received an extension for reasonable cause, one percent of the tax shall be added for each 30 days or fraction thereof elapsing between the due date of the return and the date on which it is actually filed. The minimum penalty is five dollars.

(b) *Failure by employer to file statement.* Any employer required to furnish a written statement who willfully failed to file such statement on the date prescribed, except with regard to any extension of time for filing, is subject to a five dollar penalty for each statement not so filed.

(c) *Failure to file return and pay tax after demand.* In any case where the Director makes a return and assesses a tax after a taxpayer's failure or refusal to make and file a return and pay the required tax, 25 percent of the tax assessed, in addition to penalties, is added.

(d) *False and fraudulent returns.* If any part of any deficiency is due to fraud with intent to evade the tax, or any portion thereof, 50 percent of the total amount of such deficiency, in addition to penalties, is assessed and added to the deficiency assessment.

(e) *Interest.* If any tax or penalty imposed is not paid on or before the date prescribed for such payment, interest is collected, in addition to such tax and penalties, on the unpaid balance of the tax principal at the rate of six percent per annum from its due date until the date it is paid.

(f) *Lien on property.* All taxes imposed or authorized under the law are a lien upon any property of the person or business obligated to pay these taxes and may be collected by levy upon the property.

The Trust Territory income tax laws have provided that all tax information is considered privileged and that secrecy is required.

## VI. FISCAL AND OTHER INCENTIVES FOR TRADE AND INVESTMENT

Except for a few isolated cases, the Trust Territory does not specifically allow deductions or any other form of tax holiday to promote trade and investment within the Trust Territory. Copra production from unincorporated copra producers whether severally or collectively is exempted from tax. This promotes copra production and exportation of the major cash crop.

No import taxes are levied on raw materials imported into the Trust Territory for manufacturing.

No customs charges are levied on equipment and machinery required to establish and maintain a business in Micronesia. Customs charges are levied when the equipment or machinery is sold locally.

Tax rebates or refunds are allowed on goods imported into the Territory and then exported to a buyer outside of the Territory.

Tax rebates or refunds are allowed on goods damaged or not received by importers.

*Export incentives tax (Palau)*

In January 1980, the Palau District Legislature enacted the first tax incentives law in the history of the Trust Territory. This law basically relieves exporters of commodities manufactured, processed, assembled, and packaged in Palau of the tax on gross revenues on these exports. Instead, in lieu of the gross revenue tax, it levies a special export tax of one percent per year upon the net profit derived from the exempted export activities.

## APPENDIX

### Sources of information

*Code of the Trust Territory of the Pacific Islands*, with supplements. Available from the Publications Division, Trust Territory of the Pacific Islands, Saipan, CM 96950.

*Compilation of Tax and Revenue Laws in Micronesia*, 1978. Available from the Director of Finance, Trust Territory of the Pacific Islands, Saipan, CM 96950.

*Invest in Micronesia*, 1979. Available from the Director, Bureau of Resources, Trust Territory of the Pacific Islands, Saipan, CM 96950.

### Other sources of information

Director, Bureau of Resources, Trust Territory of the Pacific Islands, Saipan, CM 96950.

Director, Bureau of Finance, Trust Territory of the Pacific Islands, Saipan, CM 96950.

President, Marshall Islands Government, Majuro, Marshall Islands 96960.

President, Federated States of Micronesia, Kolonia, Ponape 96941.

District Administrator, Palau District, Koror, Palau 96940.

# IFA NEWS

## MITCHELL B. CARROLL PRIZE FOR BOKILA LOFUMBWA

On September 19, 1980, at the final meeting of the General Assembly of IFA during the Paris Congress, the Mitchell B. Carroll prize was presented to Mr. Bokila Lofumbwa for his work entitled: *Les régimes fiscaux visant à encourager les investissements directs et de portefeuille dans les pays en voie de développement, l'interaction du système fiscal zaïrois et des régimes préférentiels des Pays de l'OCDE.* The medal which goes with the prize was awarded in the presence of its founder, Dr. Mitchell B. Carroll, whose advanced age does not prevent him from taking an active part in the proceedings of IFA.

# SUDAN: New Investment Law

by Elizabeth De Brauw-Hay*

The Sudan's new investment law has been in force since April 26 of this year. The law, entitled the Encouragement of Investment Act, repeals and replaces the three laws which previously regulated investment in the Sudan, namely the Encouragement of Investment in Economic Services Act, 1973, the Development and Encouragement of Industrial Investment Act, 1974 and the Development and Encouragement of Agricultural Investment Act, 1976.

The new Act relates both to foreign and domestic investment and a clause in the Act expressly forbids discrimination on account of the nationality of the project. Investment is encouraged in the Act in the agricultural, animal, mining, industrial, transport, tourism, storage and housing fields and any other economic field subsequently prescribed by the Ministerial Committee for Investment.

Within these sectors investment will be encouraged generally in projects which:

"(a) contribute effectively to the increase of national income and widening of the base of national economy and the strengthening of its activity, or
(b) contribute to the removal of any bottlenecks obstructing development, or
(c) make available necessary services which contribute in the consolidation of economic and social development, or
(d) the production of which depends on local material or the establishment of which is encouraged for production of such materials, or
(e) assist in the realization of self sufficiency and creation of surpluses for export, or
(f) assist effectively in the consolidation of balance of payments, or
(g) make available directly or indirectly chances of employment for citizens, or
(h) have defense or strategic importance, or
(i) contribute in the realization of the objects of economic cooperation or integration with Arab and African countries".[1]

### Incentives under the Act

A number of incentives, fiscal and otherwise, are available. These include the following:

(a) Total or partial exemption for a period of up to five years from the business profits tax from the date of commencement of production. This exemption may be extended for a further period of up to five years in the case of so-called "integrated projects". These are projects requiring large investments or which, in addition to production, provide for the building of roads and provision of other essential services. This latter provision is of major importance in the Sudan where development in many sectors of the economy is severly hampered by the lack of infrastructure.

Losses incurred during the exemption period will be deemed to have been incurred during the last year of that period.

(b) Total or partial exemption may also be granted from the following duties:
(i) customs duties on machines, equipment, apparatus and imported spare parts necessary for the project, and imported raw, manufactured and intermediary materials necessary for the project which cannot be found locally in the required quality and quantity;
(ii) import duties on manufactured or semi-manufactured goods arising from the project;
(iii) any other duties and taxes imposed on the project. This would presumably include the development tax imposed on virtually all imports and exports and import surcharges;
(iv) exemption — total or partial — from excise duties on locally produced materials and commodities required for the project.

(c) Projects will also be given exemption from local taxes unless the locality involved obtains the consent of the Minister of finance to impose such taxes.

Other incentives of a non-fiscal nature include reductions in electricity and freight rates, allotment of land necessary for the establishment of the project at reduced prices, protection of the production of a new project for a limited (but unspecified) period by means of raising customs duties on or restricting imports of competing products and preferential facilities for projects established in less developed regions.

### Guarantees under the Act

Remittance is guaranteed of profits from foreign capital invested in a project and interest on foreign loans after taxes, duties, dues and other obligations due to the Sudanese government have been paid or fulfilled in the currency in which the capital or loan was imported or in any other agreed currency. Also guaranteed is the remittance of profits arising on liquidation, sale or transfer of the investment project in the currency in which the capital was imported or in any other agreed currency. Foreign capital is defined in the law[2] as:

"(a) the foreign hard currency transferred to the Sudan at the exchange price current at the time of transfer through a bank working in the Sudan for the utilization thereof in execution of a project.
(b) imported machinery, equipment and means of transport financed from abroad and necessary for the execution of the project and compatible with the technical development suitable for the Sudan, answering such specification as prescribed by the Minister.
(c) the foreign hard currency utilized on preliminary studies, feasibility studies and foundations undertaken by the investor within the limits approved by the Minister.
(d) the profits realized by the project if capitalized with the consent of the Minister or if invested with his consent in another project in accordance with the provisions of this Act.
(e) intangible assets, i.e., patents, trademarks, technical experience, etc, registered by the foreign investor for utilization in the project".

A provision does, however, exist in the new law prohibiting liquidation of a project within five years from the commencement of production.

The Act also contains a guarantee against nationalisation except where the public good is involved. Where nationalisation does, nevertheless, occur then "just" compensation at the price current at the time of nationalisation must be paid. Such compensation must be evaluated within six months from the date of nationalisation and paid within a period of five years therefrom in the currency in which the investment was originally made or in any other agreed currency.

### Miscellaneous

Other provisions of the Act deal with the procedure to be followed for obtaining the required license and the various available incentives. The conditions of cancellation thereof are also covered as is the arbitration procedure for settlement of investment disputes.

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* Senior staff member of the International Bureau of Fiscal Documentation.
1. The Encouragement of Investment Act, 1980, Article 6.
2. Ibid. Article 3.

# BIAC's* Response to the OECD's Report on Transfer Pricing and Multinational Enterprises

This paper has been prepared to supplement the comments contained in the OECD report, which it is hoped, will add to the value of the OECD report in the hands of readers.

## I. INTRODUCTION

The OECD report on "Transfer Pricing and Multinational Enterprises" is welcomed by BIAC. It is a useful contribution to efforts being made to achieve some degree of uniformity in this overly complex field, which, as the report rightly notes, is in the interest of both governments and multinational enterprises (MNE's). As noted in the report, the fact that international business and industry can be a victim of conflicting national requirements occurs all too frequently in practice. It is hoped that the report will contribute towards reducing the number of cases in which this does occur.

BIAC considers that the OECD report clearly reflects the complicated nature of the problem of intercompany transfer pricing, with all the many and varied aspects inherent in it. BIAC also warmly endorses the comment in the report that it is not possible to "lay down rules that are appropriate to every aspect of every case." This comment constitutes recognition of the fact that to draw up a manual establishing a procedure for determining whether the transfer prices within a group conform to the arm's length principle is simply not possible or feasible.

BIAC regards as significant the fact that the report provides a set of parameters which can be applied by tax authorities in forming a judgement on transfer prices and pricing structures within a group. The implicit recognition that there is no such thing as "the right price", but that, in fact, the arm's length principle contemplates a range of prices, prompts BIAC again to express the view that managerial flexibility in regard to transfer pricing policy within a group must not be preempted by revenue authorities. Once it has been established by appropriate means that prices and pricing within a group are maintained within this range, tax authorities should refrain from attempting to apply adjustments. In such a situation the transfer pricing policy of an MNE group should simply not be susceptible to change under pressure from a Revenue examiner; in other words, it should be respected and accepted.

BIAC concurs enthusiastically with the view of the OECD report that the "so-called global methods" of allocating profits within a group of companies are entirely inappropriate to a proper determination of an arm's length price. Such an approach is not only incompatible with the arm's length principle, but it opens the door to taxation on an arbitrary basis and thus potential double taxation. Accordingly, BIAC commends OECD for including this comment in the report, with the anticipation that it will deter the use of the global method by OECD member states as well as non-member states whose MNEs engage in transactions with MNEs in member states.

While in the more detailed analysis of the OECD report to follow, some criticism is expressed on certain points, OECD should understand that this has not been done with any intent to detract from the overall impact of the report. As already mentioned, BIAC considers that the OECD study provides a clear picture of the myriad of problems in the area of transfer pricing.

On the other hand, as expected, the report has been prepared from the vantage point of the tax authorities, who are confronted with a formidable task of having to pass judgement on a countless variety of intragroup pricing practices. This inevitably leads to an approach to the problem from a perspective which differs in a number of respects from the perspective of business and industry. These points are dealt with in more detail below.

BIAC emphasizes that fiscal authorities should not permit themselves the luxury of hindsight when making adjustment to transfer prices. This point is partially met in the report where it is stated that tax authorities should not substitute hypothetical transactions or their own commercial judgement in relation to the transactions at the time they were concluded. BIAC would have liked to see a more positive statement that when examining the actual transactions and the commercial judgement of the enterprises, it is not permissible to use facts which were not available to the enterprise at the time.

## II. GENERAL

1. The language in several places in the text conveys the view that an MNE can use transfer pricing as a device for artificially shifting profits so as to minimize its world-wide tax burden. The report seems to emphasize the battle by revenue authorities against tax evasion. This approach, however, fails to recognize the fact that the possibility of tax evasion, as well as the means of combating it, are only one, perhaps minor, aspect of the problem. In fact, it should be noted that actual cases of abuse in the transfer pricing area in recent years are probably minimal since pricing policies are generally established from a business point of view. The more significant aspect of the problem stems from the fact

* Published with the kind permission of BIAC (Business and Advisory Committee to OECD). This BIAC report was drafted in January 1980.

that transnational movements of goods and services within an MNE involve the fiscal sovereignty of different countries, and that an MNE is faced with the sometimes conflicting views of these countries regarding their respective right to levy taxes on the income generated by cross border transactions. Where, for example, there are transactions within an MNE involving two countries having the same approximate rate of taxation, then it will generally not matter to the MNE where the profit is allocated, since the total tax liability of the group will not be substantially affected. The two tax authorities involved, however, view the matter differently, since each of these has a fiscal interest in the income allocation process and, therefore, in the observance of the arm's length principle.

The fact that this aspect of the application of the arm's length principle has been overlooked in the report surfaces with particular impact in the discussion (or lack of discussion) in the area of *corresponding adjustments* and the discussion of *central costs.*

With regard to *corresponding adjustments*, the OECD takes the view that this subject need not be dealt with since it is "a related problem, but outside the scope of this report." BIAC emphatically disagrees with this approach. Understanding that OECD will in the near future commence a study of this subject, BIAC urges this study to be undertaken and concluded expeditiously because of the uncertainties created during the period from issuance of the OECD report until some clear internationally accepted rules are accepted. No topic is more directly concerned with the entire area of transfer pricing than is the topic of corresponding adjustments, because it is inextricably wound up in establishing the demarcation of the power of the different countries involved to levy their tax. An argument is often heard that the absence of a definitive rule requiring corresponding adjustments is in the interest of tax authorities, on the grounds that the possibility of double taxation will provide an additional obstacle to prevent MNEs from attempting to reduce their tax liabilities through artificial pricing schemes. Not only does this proposition lack validity in today's economic climate, but it imposes a heavy burden upon taxpayers by making them vulnerable to arbitrary and capricious pricing adjustments proposed by examining revenue agents. The application of the arm's length principle is equally a concern of the two countries involved in the cross border transaction. Therefore, BIAC considers that the OECD report should have set forth and endorsed a mandatory system of corresponding adjustments binding on all members of the OECD.

BIAC considers this essential for the following reasons:

- The report indicates that each situation should be examined in light of its own particular facts and circumstances. Since the tax authorities in different countries will very probably attach different weight to the various elements in a transfer pricing practice of an MNE, the wish expressed by the OECD that "a common approach ... should help to reduce the need for any such corresponding adjustments" will be of little value of taxpayers in reducing double taxation.
- The same rationale may apply as to the methods mentioned in the report for determining whether prices conform to the arm's length principle, in that, if one country adopts the "cost plus" method and another adopts the "resale minus" method for the same transfer price, the result may well lead to double taxation, to the detriment of the taxpayer.

Although the report will obviously have a direct impact on relations between OECD countries, it seems to BIAC that it may well influence relations between member and non-member states, as well as among non-member states. Since it seems that such non-member countries base their taxation policies on a mixture of OECD concepts and principles other than those adopted in the OECD countries, the failure to deal adequately with corresponding adjustments may raise the specter of increasing cases of double taxation in non-member states opting to follow the principles laid out in *this* report.

In summary, BIAC concludes that it is essential to the effectiveness of what OECD is attempting to accomplish in the transfer pricing report that the subject of corresponding adjustment be definitely dealt with. The fact that this was not done is regrettable, BIAC hopes that consideration of this subject be undertaken and concluded as rapidly as possible.

With regard to the treatment of *costs of central services and activities*, the OECD report devotes a great deal of attention to the means by which tax authorities can determine whether or not is is appropriate for subsidiary companies to bear all or some portion of such costs. It is not stated in the report, however, that such costs should, in any event, be deductible in some jurisdiction. The report should have acknowledged this fact, to provide assurance that MNEs will not suffer double taxation arising out of disputes with the tax authorities of the MNE's home and host countries.

2. Although BIAC realizes that subdividing the subject into its separate components, dealing with each in a separate chapter of the report, was necessary for analytical purposes, this approach could conceivably give rise to misunderstandings between taxpayers and the tax authorities. This fact should have been recognized and pointed out in the preface of the report to avoid such a potential misapplication of the report. It is indicated that it is not always possible to draw a clear distinction between, for example, the transfer of know-how and services related thereto. BIAC believes that the various concerned tax authorities are extremely likely to use the specific methods set forth in the OECD report in their review of each individual type of intercompany transaction within an MNE. The danger arises that, without specific guidance in the report, an overall consideration of the totality of relationships between the entities of the group will be ignored. In effect, tax officials will not see the forest for the trees. In such cases, although it may seem that the arm's length principle has not been observed with regard to certain of the individual intercompany transactions between two associated enterprises, conformity to the arm's length principle will nevertheless have been achieved when the picture is reviewed as a whole, as for example, by means of package deals or set-offs. In this regard, incidentally, BIAC notes

that, contrary to the implication in the OECD report, such arrangements are not uncommon in third-party relationships.

For this reason BIAC wishes to emphasize that, in any scrutiny of transfer pricing with an MNE, initial emphasis should be placed on a judgment of the totality of overall relations within the enterprise, over a reasonable period of time, and this should be borne in mind while reviewing the separate categories of transactions within the area of transfer pricing.

## III. PARTICULAR POINTS

### 1. Burden of proof

As noted above, the OECD report appears to espouse the concept that generally MNEs adopt transfer pricing schemes as a device to reduce artificially their tax liabilities (a view with which BIAC does not concur). This could lead to the assumption that the burden of proof (of the appropiateness of transfer prices) is to be placed upon the MNEs. In BIAC's view, the initial burden of proof (that a particular transfer price does not comply with the arm's length principle) should rest with the relevant tax authorities.

### 2. Benefit test

In the chapters covering transfer of technology and intragroup services, the report suggests that a group member must demonstrate that it has derived a benefit (or was expected to derive a benefit) in consideration for payments made to another affiliate (often the parent) for services or certain intangible property rights. This concept is acceptable insofar as it relates to specific services rendered and specific property transferred. In addition, however, a parent company of a group often incurs substantial costs for central activities carried on to benefit the group as a whole, rather than to benefit any one or more specific affiliates. For example, know-how of all kinds is available centrally for all members of the group to avail themselves of, if desirable or necessary; and a continuous stream of information of all sorts (e.g., marketing, advertising, technical, etc.) flows to the subsidiary companies. It seems to BIAC that the members of a group should make an appropriate contribution toward defraying these costs, whether or not specific benefit (actual or intended) can be demonstrated.

The performance of central services and central activities is inherent in the very nature of a multinational group, and, accordingly, it is logical to conclude that the enterprise as a whole is benefited by the costs incurred for activities carried on by the headquarters unit. In many cases, however, it will not be possible to substantiate that an immediate benefit has been conferred upon the group members, even though they are called upon to bear an allocable portion of such central costs. BIAC believes that it is reasonable that every group member of an MNE should pay its share of those central costs from which it can expect to benefit collectively, each respective share being determined by an appropriate apportionment formula.

### 3. Information

In dealing with the subject of information flows, both the provision of information by the enterprises itself and the exchange of information between the tax authorities of the relevant States should be considered.

*A. Information provided by the enterprise*

BIAC recognizes the obligation of MNEs to co-operate with the tax authorities in a pricing examination as regards the providing of information, as long as the information requested by the authorities is relevant to the examination in process and is necessary to allow the authorities a basis upon which to form a proper judgement of the pricing structure under study. It must be emphasized, however, that the tax authorities involved in a pricing examination should *not* request from any member of the group detailed information on transfer pricing in transactions in which the particular tax authority has no direct interest.

Moreover, where there is no actual evidence that the arm's length principle has *not* been observed, the tax authorities should not be permitted to go on a "fishing expedition". If the obligation to provide information were, in fact, to encompass the type of data mentioned in the preceding two sentences, it would impose a heavy and unjustifiable burden on an MNE, particularly since the MNE could be confronted with such requests from tax authorities in many countries of the world.

*B. Exchange of information between States*

BIAC strongly recommends that information to be exchanged between states on transfer pricing should relate only to such matters as are relevant to an actual pricing examination; furthermore, such information as is exchanged, should only be used for the specific purpose of the particular examination. Further, it is important that any exchange of information does not involve the disclosure of business secrets. BIAC also believes that, before any such exchange of data takes place between tax authorities, the enterprise concerned should be informed and given an opportunity to register any objection it might have to such exchange.

### 4. Marginal pricing

BIAC believes that proper attention should be devoted to the subject of marginal pricing, which is missing from the report. The failure to discuss this concept conveys an impression that marginal pricing occurs only by way of exception. BIAC wishes to emphasize that marginal costing and pricing are normal practices. As a result of the non-treatment of the subject, BIAC fears that tax authorities in a pricing examination of one or more affiliates of an MNE may reach erroneous conclusions in cases in which intercompany pricing has been based on a marginal costing method. Accordingly, BIAC strongly urges that the OECD consider this subject for inclusion in a subsequent report and, in fact, is undertaking a study of this topic for the use of OECD in its deliberations.

## 5. Accounting methods

The tax authorities of two countries, when reviewing the transaction between two affiliates of an MNE in each of their countries, should be required to accept uniform methods of calculating transfer prices with respect to the transactions under study. To do otherwise would open up a potential for distortion and ultimately result in double taxation (i.e., taxation of an amount of profit in both countries in the aggregate exceeding the actual profit). BIAC therefore makes a plea that the MNE's own method of calculating prices should be accepted if in conformity with generally accepted accounting practices consistently applied.

## 6. Shareholders costs

BIAC concurs with the report insofar as it treats shareholder (stewardship) costs as costs of the parent company only, not allocable to other members of the group. BIAC does not agree, however, with the overly broad interpretation of what constitutes shareholders costs.

Shareholders costs should be limited to only those costs incurred by a parent company *solely* in its capacity as a shareholder (investor) in the other group affiliates. It should not include any costs attributable to coordinating the various business activities of the group. The costs of internal auditors, for example, should not be included as a shareholder cost. Since examinations carried out by internal auditors are primarily intended to provide information to the parent and the group members which is, *inter alia*, used for management purposes, the tion that the result of an internal audit merely serves to protect the investment of the parent company is not correct, and is a misconception of the role of the internal audit function.

BIAC cautions against interpreting the concept of shareholders costs too broadly, inasmuch as the result could be to create a sitution where a significant portion of the central costs of a group would effectively not be deductible anywhere.

## 7. Retroactivity

In view of the fact that the transfer price in every cross border transaction involves at least two jurisdictions and that an MNE must, for business considerations, be afforded the opportunity to arrange a suitable transfer pricing structure, any pricing structure, once acceptable to the tax authorities in question, should not subsequently be challenged by such tax authorities, unless circumstances have substantially changed since original acceptance. Even in such a situation, tax authorities should proceed very cautiously in proposing any retroactive price adjustments, as this may create particularly difficult problems, including the threat of double taxation, for the MNE concerned.

## 8. Advance rulings

BIAC considers it desirable to offer an MNE the opportunity to satisfy itself in advance whether or not a particular approach, structure or system contemplated for use in intercompany transfer pricing is fiscally acceptable. This can be accomplished through the mechanism of advance rulings whereby an MNE could consult with the tax administration(s) in advance of implementing a pricing structure and request the views of the administration(s) involved. This could be done formally or informally, depending upon the customs of the particular country. Once approved, however, the pricing system should not be subject to challenge; in other words, the ruling should be binding on the tax administration. BIAC believes that further study of this matter is warranted.

# IV. CONCLUSION

BIAC wishes once again to express its appreciation to the OECD for the Report on Transfer Pricing and Multinational Enterprises. It is a signal achievement. It is evident, however, that the transfer price problem has many and varied aspects, and that it is not possible to treat the subject in its entirety in a report of this scope. Moreover, several of the issues discussed, including those commented upon above, have been treated primarily from the perspective of the government (i.e., the revenue authorities), without giving full weight to the taxpayer's viewpoint.

As we are informed that OECD will continue its work on areas not covered in the report, BIAC is pleased to offer its assistance and co-operation in such endeavor.

# IFA NEWS

## SOME HIGHLIGHTS

### FROM THE SECRETARY GENERAL'S 1979-80 REPORT PRESENTED AT THE PARIS CONGRESS 1980.

#### IN GENERAL

The Secretary General, Prof. Dr. Jan H. Christiaanse, paid special attention to the administrative aspects of IFA. The appointment of Prof. Dr. J.C.L. Huiskamp (Director of the Fiscal Economic Institute of the Erasmus University in Rotterdam) as Assistant Secretary General will enable IFA to fulfill better certain tasks which have in the past received too little attention. Prof. Huiskamp will in particular be involved with the preparatory work for Seminars held at Congresses. This year he edited the papers for the Seminar entitled: "Recourse to Tax Havens — Use and Abuse" for the Paris Congress. Prof. Huiskamp is further responsible for the contact with IFA liaison officers to various international organizations and he takes part in the sessions of the Permanent Scientific Committee which is the scientific arm of IFA. He will also coordinate the work and the promotion of the Mitchell B. Carroll Prize.

The Permanent Scientific Committee's decision to prepare for Congresses two years in advance has added to the work load of the General Secretariat, which has been busy with preparations for the Paris, Berlin and Montreal Congresses in 1979-80.

Recent changes in the Dutch legislation governing associations made it necessary to amend the statutes of IFA. This proved to be a time-consuming task which took much of the General Secretariat's time.

The General Secretariat, desirous to be kept informed of the activities of the national branches, has requested the supply of information on a regular basis. This information will be published under the heading "IFA News" in the *Bulletin for international fiscal documentation.* It is, of course, vital that the national branches keep the General Secretariat informed of their work.

#### COPENHAGEN CONGRESS

The 33rd Congress held in Copenhagen organized by the Danish Branch under the supervision of Mr. Aa. Spang-Hansen was very successful. General reporters were Prof. Th. Nielsen (Denmark) and Mr. Gerhard Laule (Germany) and discussion leaders Mr. J.F. Avery-Jones (U.K.) and Prof. I. Claeys Boúúaert (Belgium). Two highly interesting seminars were held, one chaired by Prof. Stanley Surrey (U.S.A.) and the other by Prof. Dr. Gustaf Lindencrona (Sweden) and booklets containing information as a basis for these discussions were distributed by IFA.

#### MITCHELL B. CARROLL PRIZE

At the Copenhagen Congress Prof. Dr. Klaus Vogel (Germany), chairman of the jury, handed the medal to Mr. Edwardes-Ker for his work: "International Tax Treaties Service". For the 1980 prize there are four competitors:

*H.M. Liebman* (Belgium):
— A Formula for Tax-Sparing Credits in U.S. Tax Treaties with Developing Countries.

*Jean-Pierre Panis* (France):
— Tax Harmonisation and Industrial Policy within the EEC; Company Taxation: Corporate Income Tax.

*Dr. A. Storck* (Germany):
— Ausländische Betriebstätten im Ertrags- und Vermögenssteuerrecht.

*Lofumbwa Bokila* (Belgium):
— Les régimes fiscaux visant à encourager les investissements directs et de portefeuille dans les pays en voie de développement, l'interaction du système fiscal zaïrois et des régimes préférentiels des Pays de l'OCDE.*

#### PARIS CONGRESS 1980

The two subjects of the Paris Congress are in the capable hands of the two General Reporters:
— Mr. Guy Delorme (France) for Subject I, "The dialogue between the tax administration and taxpayer up to the filing of the tax return"; and
— Mr. Robert J. Patrick (U.S.A.) for Subject II, "Rules for determining income and expenses as domestic or foreign".

Prof. J. van Houtte (Belgium), honorary president of IFA, is prepared to act as discussion leader for Subject I and Mr. P. Kerlan (France) for Subject II. Prof. Vedel (France) will be the chairman of the working session on Subject I and Prof. Dr. Th. Nielsen (Denmark) of the working session on Subject II.

#### FUTURE CONGRESSES

**1. Berlin Congress 1981**

During the Spring meeting of the Permanent Scientific Committee (PSC) the directives for the Berlin Congress were discussed. The topics are:

Subject I — Mutual agreement — procedure and practice
General reporter: Dr. K. Koch (German Federal Republic)

Subject II — Unilateral measures to prevent double taxation
General reporter: Dr. D. Juch (Netherlands)

The PSC decided to hold Seminar I on the subject "Taxation of income arising from the international seabed" (this title may be subject to rephrasing) instead of on "The OECD Model Convention on Estate Taxes" since the pertinent OECD Report scheduled to be published in Spring 1981 may be delayed.

The Berlin Congress will be held from September 21-25, 1981.

* See page 507.

## 2. Montreal Congress 1982

At the same PSC meeting the topics for the Montreal Congress were established:

Subject I — The tax treatment of interest in international economic transactions
General reporter: Prof. E. Höhn (Switzerland)

Subject II — Taxation of transportation of passengers and goods in international traffic
General reporter: Mr. G. Coulombe (Canada)

## 3. Other Congresses

Further congresses are scheduled in Venice (Italy) in 1983, in Buenos Aires (Argentina) in 1984 and in London (United Kingdom) in 1985.

# IFA OFFICERS COME AND GO

Mr. C.J. Berg (Australia) and Mr. R. Baconnier (France) joined the Permanent Scientific Committee whereas Mr. P. Kerlan (France) left after a long and active participation.

Mr. K. Beusch (Germany), Mr. A. Elvinger (Luxembourg) and Dr. A. Toffoli Tavolaro (Brazil), elected at the Copenhagen Congress, took their posts in the Executive Committtee.

Prof. P. Sibille was welcomed as President of the Editorial Committee. Mr. M. Laxan will be proposed for nomination as President-Elect of IFA during the Paris Congress. [1] Mr. R.M. Hammer (U.S.A.), Mr. J.L. Perez (Spain) and Mr. K. Beusch (Germany) were elected as 1st, 2nd and 3rd Vice Presidents respectively.

Mr. P.F. Vineberg (Canada) will be due for statutory retirement at the meeting of the Executive Committee at the Paris Congress.

Mr. D.E. Richards acted for the last time as President of the Nominations Committee.

# NATIONAL BRANCHES

During the Copenhagen Congress two new national branches were recognized: Hong Kong and Colombia. Applications for such recognition were received from Indonesia and Malaysia which will be recognized during the Paris Congress. [2]

# NUMBER OF MEMBERS

IFA had 5,659 members in January 1980 (the last count in March 1979 was 5,427).

# MEMBERSHIP FEES

The membership fees will be increased for 1980/81:
US$ 38 for individual members of national IFA branches;
US$ 40 for direct individual members of IFA;
US$ 90 for corporate members, both direct and of national branches.

1. His nomination was approved by the General Assembly of IFA during its session on September 19, 1980.
2. Their recognition was approved by the General Assembly in the above meeting (note 1).
3. The increase was approved by the General Assembly in the above meeting (note 1).

# AUSTRIA

The Austrian Branch of IFA reports the following on its activities during the first half of 1980.

## 1. Meetings

On May 9 and 10, 1980 the Austrian and German Branches organised a workshop in Salzburg. The following subjects were discussed:

(i) The German VAT reform which became effective on January 1, 1980 and which was partly based on the Eighth EEC Directive on VAT. Special attention was paid to the place of rendering of services, the refund procedure and the limitation of the tax jurisdiction.

(ii) The current tax situation in Austria and the Federal Republic of Germany. During World War II German tax law was applicable in Austria and the papers read showed to what extent the developments in Austrian and German tax law have diverged, but in some cases tend to similar solutions.

(iii) Dr. Bechinie, the President of the Austrian Branch, read a paper dealing with the work of the Austrian Tax Reform Committee which concluded its work in the beginning of 1980. He reported in detail on the Committee's proposals but pointed out that their implementation will necessarily depend on budgetary circumstances, since it is not intended to reduce or increase taxes.
He also mentioned some subjects which are currently in the center of interest, like the reform of tax rates and the introduction of a withholding tax on interest from savings accounts and bonds. Although the Tax Reform Committee has completed its task, some sub-committees continue to study the structure of the Austrian income tax law and the reform of the present investment incentives.

(iv) A German speaker discussed some fundamental problems with respect to taxation of families, the envisaged tax rate reform and amendments of the unilateral relief for double taxation.

(v) Officials of Austrian and German local tax administrations (from the city of Salzburg and from Bavaria, respectively) discussed the functioning of the mutual agreement procedure under the Austrian-German double taxation treaty. The results are very favorable and the fact that also lower tax administrations have been involved leads to a substantially less time-consuming procedure.

On June 17, 1980 the General Assembly of the Austrian Branch convened. Considering the success of the meeting in Salzburg the members expressed their wish to continue the cooperation with the German Branch in 1981.

## 2. Members honored

Dr. Robert Halpern, vice-president of the Austrian Branch, mem-

Dr. Alexander Hörtlehner.

Prof. Dr. Robert Halpern

ber of the General Council of Central IFA and Chairman of its Finance Committee, received from the President of the Austrian Federal Republic the title of "Professor".

Dr. Alexander Hörtlehner, the Secretary of the Austrian Branch, received the Gold Medal for Merit of the Austrian Republic during a ceremony at the Ministry for Trade.

# BRAZIL

The Brazilian Branch announces that from November 16-21, 1980 a joint congress will be held entitled:

I Congresso Internacional de Estudios Tributários
IV Congresso Interamericano de Tributação

The subject of these congresses is: Municipal tax policy facing urban concentration — a search for a new system.

Speakers will include:

| | |
|---|---|
| Ives Gandra da Silva Martins, Geraldo Ataliba, Ruy Barbosa Nogueira, Bernardo Ribeiro de Moraes, Aires Fernandino Barreto, Gilberto de Ulhôa Canto, Souto Maior Borges | Brazil |
| Manuel de Juano | Argentina |
| Carlos A. Mersan | Paraguay |
| Ramón Valdés Costa | Uruguay |
| Euzébio Gonzales Garcia | Spain |
| Victo Uckmar | Italy |
| Sergio Francisco de la Garza | Mexico |
| Klaus Vogel | Germany |

Further information from the Secretariat:
Rua Juataba no. 20
CEP 05441 SAO PAULO
Brasil

# SPAIN

The Spanish Branch of IFA reports that their membership is gradually increasing: from 70 to 79 during 1979 and it is hoped that this trend will continue in 1980. With respect to its activities it indicates that it is involved in the preparation of the national reports for the Paris Congress of IFA and that it took part in the Congress of the I.I.F.P. Its members will also contribute to the IX "Jornadas Luso-Hispano-Americanas de Derecho Financeiro" which will take place during 29 September — 2 October 1980 in Oporto (Portugal). Subjects to be discussed at this meeting include: (i) the influence of taxation on the financing of enterprises, and (ii) the family as a taxable unit.

The foundation of a tax journal in the Portuguese and Spanish languages is envisaged, which will act as the official organ of the Portuguese and Spanish-speaking Branches of IFA and which will be entitled "Fiscus". Contact for this purpose has been established with the Argentine and Portuguese Branches.

The Spanish Branch of IFA is also involved in the creation of a national association of taxpayers. At this moment the charter and by-laws have been drafted and officially approved.

Finally, the Spanish branch participates with the Chamber of Commerce and Industry in a center for the study of taxation and economics which was created in 1960. The main goal of this center is the training of tax experts, accountants and business consultants. The center is managed by Latin American experts.

# SWEDEN

The annual general meeting of the Swedish Branch, chaired by Mr. C.O. Sandström, was held on May 28, 1980. After the meeting Mr. Hans Pehrson of the National Tax Board spoke on "The development in Sweden of international tax control".

# UNITED KINGDOM

The Annual General Meeting of the British Branch of IFA was held on May 29, 1980.

Mr. R.T. Esam was reelected Chairman, and Mr. D.A. Clarke, Mr. C.J. Crowe and Mr. D.F.A. Davidson were reelected Vice Chairmen. For 1980-81 the Branch's Committee comprises the following persons:

| | |
|---|---|
| Mr. J.F. Avery Jones | Mr. E.J. Henbrey |
| Mr. I.D. Barnett | Mr. A. Lord |
| Mr. J.B. Bracewell-Milnes | Mr. J.D.B. Oliver |
| Mr. J.F. Chown | Mr. J.S. Phillips |
| Mr. H.L. Duncan | Mr. H.R. Roe |
| Miss M.E. Erskine | Mr. B. Sabine |
| Mr. W.K. Evans | Mr. F.H. Seale |
| Mr. D.E. Evennett | Mr. C.H. Thomas |
| Mr. M.J. Gammie | Mr. D.N.C. Gray |

The U.K. Branch met on September 30, 1980 to discuss the draft national report on the first subject for the 1981 Congress in Berlin: "Mutual agreement — procedure and practice". The national reporter on the first subject is Mr. Ivor Barnett, Tax Adviser, Beecham Group Ltd. On October 21, 1980 the meeting discussed the draft national report on the second subject: "Unilateral measures to prevent double taxation". Reporter is Mr. Harvey McGregor, Q.C.

On November 4, 1980 there will be a talk on "Recent developments in U.S. tax" by Mr. W. Donald Knight, Jr.

### IFA Manchester Sub-branch

The following programme was established:

October 9, 1980: Mr. John Avery Jones on "VAT pitfalls".

November 4, 1980: Mr. Walter Richards (GKN Ltd) will lead a tax workship dealing with interest paid to non-residents. It is hoped to examine (and provoke discussion on) grey areas surrounding foreign loans, foreign borrowing vehicles, Eurobonds, Sections 248 and 249, interaction of interest payments and double taxation relief, the effect of double taxation agreements etc.

December 3, 1980: Mr. John Stevenson (Inland Revenue, Somerset House) on "Practical problems relating to Section 485".

February 17, 1981: Sir Norman Price (former Chairman of the Board of Inland Revenue) on "EEC finance, including Revenue aspects such as the U.K. contribution".

March 4, 1981: Mr. Peter Holdstock (Price Waterhouse & Co, London) will lead a tax workship on "Outward direct investments".

# People's Republic of China

## Promulgation of the Regulations on Special Economic Zones in Guangdong Province

On August 26, 1980, the 15th Session of the Standing Committee of the Fifth National People's Congress of the People's Republic of China passed the Regulations on Special Economic Zones in Guangdong Province as submitted by the State Council.

Plans for the establishment of such Special Economic Zones in China have been in existence for some time now, and, indeed, some work has been done towards the establishment thereof particularly in Guangdong and Fujian Provinces. [1]

The present regulations concern the Special Economic Zones in an area in the South of Guangdong Province, namely in Shenzhen (Shekou), Zhuhai and Shantou.

The Shenzhen (Shekou) Zone was established earlier this year; the BULLETIN FOR INTERNATIONAL FISCAL DOCUMENTATION reported on this Zone. [2] One of the most significant differences between the rules then established for Shenzhen (Shekou) and the present Regulations concerns the tax rate. This was originally set at 10 percent of taxable profit whereas the Regulations for the entire Guangdong Province have now promulgated a rate of 15 percent. We have been informed by the competent authority that the 10 percent rate will apply for all the agreements in Shenzhen (Shekou) which were signed before August 27, 1980; agreements signed after that date will, however, be governed by the Regulations below.

The following translation has been released by XINHUA. The headings preceding the Articles were, however, added by the International Bureau of Fiscal Documentation.

## REGULATIONS OF THE PEOPLE'S REPUBLIC OF CHINA ON SPECIAL ECONOMIC ZONES IN GUANGDONG PROVINCE

### Chapter I — General principles

*Article 1 — Location and type of activities*
Certain areas are delineated from the three cities of Shenzhen, Zhuhai and Shantou in Guangdong Province to form special economic zones (hereinafter referred to as special zones) in order to develop external economic cooperation and technical exchanges and promote the socialist modernization program. In the special zones, foreign citizens, overseas Chinese, compatriots in Hong Kong and Macau and their companies and enterprises (hereinafter referred to as investors) are encouraged to open factories or set up enterprises and other establishments with their own investment or undertake joint ventures with Chinese investment, and their assets, due profits and other legitimate rights and interests are legally protected.

*Article 2 — Legal framework*
Enterprises and individuals in the special zones must abide by the laws, decrees and related regulations of the People's Republic of China. Where there are specific provisions contained in the present regulations, they have to be observed as stipulated herewith.

*Article 3 — Administrative authority*
A Guangdong Provincial Administration of Special Economic Zones is set up to exercise unified management of the special zones on behalf of the Guangdong Provincial People's Government.

*Article 4 — Scope of operation*
In the special zones investors are offered a wide scope of operation, favourable conditions for such operation are created, and stable business sites are guaranteed. All items of industry, agriculture, livestock breeding, fish breeding and poultry farming, tourism, housing and construction, research and manufacture involving high technologies and techniques that have positive significance in international economic cooperation and technical exchanges, as well as other trades of common interest to investors and the Chinese side, can be established with foreign investment or in joint venture with Chinese investment.

*Article 5 — Development of the infrastructure*
Land-levelling projects and various public utilities in the special zones such as water supply, drainage, power supply, roads, wharves, communications and warehouses, are undertaken by the Guangdong Provincial Administration of Special Economic Zones. When necessary, foreign capital participation in their development can be considered.

*Article 6 — Advisory board*
Specialists at home and abroad and personages who are enthusiastic about China's modernization program will be invited by each of the special zones to form an advisory board as a consultative body for that special zone.

### Chapter II — Registration and operation

*Article 7 — Registration application*
Investors wishing to open factories or take up various economic undertakings with investment should apply to the Guangdong Provincial Administration of the Special Economic Zones, and will be issued licenses of registry and use of land after examination and approval.

*Article 8 — Banking and insurance*
Investors can open accounts and deal with matters related to foreign exchange in the Bank of China in the special zones or other banks set up in the special zones with China's approval.
Investors can apply for insurance policies at the People's Insurance Company of China in the special zones and other insurance companies set up in the special zones with China's approval.

*Article 9 — Sale of products*
Products of the enterprises in the special zones are to be sold on the international market. If an enterprise wants to sell its products in the domestic market in China, it must have the approval of the Guangdong Provincial Administration of Special Economic Zones and pay customs duties.

*Article 10 — Operation; Employment of foreign personnel*
Investors can operate their enterprises independently in the special zones and

1. A detailed survey of Special Economic Zones in the People's Republic of China will be included in a forthcoming supplement of our loose-leaf publication: TAXES AND INVESTMENT IN ASIA AND THE PACIFIC, Chapter on the People's Republic of China.
2. BULLETIN FOR INTERNATIONAL FISCAL DOCUMENTATION, April 1980, at 171 ff.

employ foreign personnel for technical and administrative work.

*Article 11 — Termination of activities*
If investors want to terminate their business in the special zones, they should submit the reasons for their termination to the Guangdong Provincial Administration of Special Economic Zones, go through related procedures and clear the debts. The assets of the closed enterprises can be transferred and the funds can be remitted out of China.

## Chapter III — Preferential treatment

*Article 12 — Provision of land*
The land in the special zones remains the property of the People's Republic of China. Land to be used by investors will be provided according to the actual needs, and the length of tenure, rent and method of payment will be given favourable consideration according to the different trades and uses. Concrete methods will be specified separately.

*Article 13 — Importation of equipment*
Machinery, spare parts, raw materials, vehicles and other means of production for the enterprises in the special zones are exempted from import duties. The necessary consumer goods shall be subjected to full or lower import duties or exempted, depending on the merits of each case. Imports of the above-mentioned goods and exports of products of the special zones must go through existing customs procedures.

*Article 14 — Income tax on enterprises*
The rate of income tax levied on the enterprises in the special zones is to be 15 percent. Special preferential treatment will be given to enterprises established within two years of the promulgation of these regulations, enterprises with an investment of US$5 million or more, and enterprises involving higher technologies or having a longer cycle of capital turnover.

*Article 15 — Remittance abroad*
Legitimate after-tax profits of the investors, salaries and other proper earnings after paying personal income tax of the foreign, overseas Chinese and Hong Kong and Macao workers and staff members of the enterprises in the special zones can be remitted out of China through the Bankc of China or other banks in the special zones in line with the zone's foreign exchange control measures.

*Article 16 — Reinvestment*
Investors who reinvest their profits in the special zones for five years and longer may apply for exemption of income tax on profits from such reinvestment.

*Article 17 — Use of domestic items*
Enterprises in the special zones are encouraged to use China-made machinery, raw materials and other goods. Preferential prices will be offered on the basis of the export prices of China's similar commodities and settled in foreign exchange. These products and materials can be shipped direct to the special zones with the vouchers of the selling units.

*Article 18 — Entry and exit procedures*
Entry and exit procedures will be simplified and convenience offered to the foreign, overseas Chinese and compatriots in Hong Kong and Macau going in and out of the special zones.

## Chapter IV — Labour management

*Article 19 — Provision of labour*
Labour service companies are to be set up in each of the special zones. Chinese staff members and workers to be employed by enterprises in the special zones are to be recommended by the local labour service companies or recruited by the investors with the consent of the Guangdong Provincial Administration of Special Economic Zones. Enterprises can test them before employment and sign labour contracts with them.

*Article 20 — Performance and dismissal*
The employees of the enterprises in the special zones are to be managed by the enterprises according to their business requirements, and, if necessary, can be dismissed in line with the provisions of the labour contracts.
Employees of the enterprises in the special zones can submit resignation to their enterprises according to the provisions of the labour contracts.

*Article 21 — Remuneration*
Scales and forms of the wages, award methods, labour insurance and various state subsidies of the Chinese staff members and workers in the enterprises are to be included in the contracts signed between the enterprises and the employees in accordance with the stipulations of the Guangdong Provincial Administration of Special Economic Zones in Guangdong province.

*Article 22 — Labour protection*
Enterprises in the special zones should have the necessary measures for labour protection to ensure that the staff members and workers work in safe and hygienic conditions.

## Chapter V — Administration

*Article 23 — Supervisory body*
The Guangdong Provincial Administration of Special Economic Zones exercises the following functions:
1. Draw up development plans for the special zones and organize for their implementation.
2. Examine and approve investment projects of investors in the special zones.
3. Deal with the registration of industrial and commercial enterprises in the special zones and with land allotment.
4. Coordinate the working relations among the banking, insurance, taxation, customs, frontier inspection, postal and telecommunications and other organizations in the special zones.
5. Provide staff members and workers needed by the enterprises in the special zones and protect the legitimate rights and interests of these staff members and workers.
6. Run education, cultural, health and other public welfare facilities in the special zones.
7. Maintain law and order in the special zones and protect according to law the persons and properties in the special zones from encroachment.

*Article 24 — Administrative agencies*
The Shenzhen Special Zone is under the direct jurisdiction of the Guangdong Provincial Administration of Special Economic Zones. Necessary agencies are to be set up in the Zhuhai and Shantou Special Zones.

*Article 25 — Business promotion company*
A Guangdong Provincial Special Economic Zones Development Company is to be set up to cope with the economic activities in the special zones. Its scope of business includes fund-raising and trust investment, operating enterprises or joint ventures with investors in the special zones, acting as agents for the investors in the special zones in matters related to sales and purchases with other parts of China outside the special zones, and providing services for business talks.

## Chapter VI — Appendix

*Article 26 — Entry into force*
These regulations shall be enforced after their adoption by the Guangdong Provincial People's Congress and after they have been submitted to and approved by the Standing Committee of the National People's Congress of the People's Republic of China.

# TAX GLOSSARY

*by H.W.T. PEPPER* *

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**TAX SPARING** — Where one country grants a tax holiday in respect of profits, e.g., from a "pioneer" enterprise, and/or to the dividends declared out of those profits, and the income belongs to a resident of another country with which a double tax treaty has been made, the other country may grant "tax-sparing" relief. The "sparing" amounts to a "recognition", by the county of residence, of the tax given up by the other country in its tax holidays and giving relief as if the tax had actually been charged and paid in the country where the enterprise is operating. The tax thus recognized is sometimes known as PHANTOM TAX (q.v.).

**TAX THRESHOLD** — The level (of income, capital, sales, etc.) at which tax commences to be levied. A taxpayer with income below the threshold level would be exempt from income tax, an estate below a certain value would be exempt from death duties, and a trader whose sales are below a certain threshold is excluded from Value Added Tax (though in that case the goods he buys will contain a tax element which will not ordinarily be available for refund).

**TAXABLE BASE** — The "taxable base" or "tax base" is a term used in connection with a tax or duty to indicate what is covered by the levy. For example, an income tax might apply to all income received within a country and foreign income remitted to the taxing country by resident taxpayers. In the case of death duties, the duty might apply to all assets situated within the country where the deceased person was domiciled, and also to all the foreign assets of such a deceased person. (See also SCOPE OF TAX, TAX-INCLUSIVE BASE.)

**TAXABLE CAPACITY** — A somewhat abstract concept as far as individuals are concerned (as regards taxes on goods where the maximum "capacity" for tax may be regarded as a point beyond which additions to the tax charge would result in DIMINISHING RETURNS (q.v.) of revenue). The capacity of individuals to pay tax is proportionate to per capita income, to the political stability of the country, the efficiency of the tax administration, and probably to the proportion of the total revenue which comes from indirect, rather than direct taxes. (See also UNMERKLICHKEIT.)

**TAXABLE EVENT** — This term is used mainly in connection with sales taxation which may be chargeable, e.g., upon a sale taking place, on delivery of goods to a customer, or on the movement of goods from the trader's premises, including in each case those goods for the internal or personal or domestic use of the business or the proprietors thereof. (See also TAX POINT.)

**TAXABLE INCOME** — Some income tax systems use the term "taxable income" to refer to all income which is by definition taxable, and under other tax codes the term may relate to the income which is actually subjected to tax rates, representing the gross or assessable income less deductions for items such as depreciation, losses, and personal reliefs.

**TAXABLE PERIOD** — Many taxes are related to a particular period of time, such as a fiscal year in the case of income taxes (which are applied to the income of the whole year). In the case of sales taxes, the tax is usually payable by reference to the sales of, transactions in, or movements of goods, or the rendering of services, within a particular period of time, and the taxpayer is usually required to pay tax on the basis of each period within a fairly short time of the end of it. Typically, the taxable period for sales taxation is either a month or a quarter of a year, but there are some instances where tax has been collected at shorter intervals, and others where, exceptionally, it has been related to a period of six months or a year.

**TAXABLE PRICE** — In the case of sales taxes, and ad valorem customs duties, where the duty or tax is a percentage of the price or value of the goods, it is usual to define the price in the tax law. For example, a manufacturer's sales tax would make a levy on certain classes of goods on the price at which the manufacturer would ordinarily sell (at arm's length) to a wholesaler, and a wholesale tax would normally define the taxable price as that at which a wholesaler would ordinarily sell the goods (in the open market) to a retailer (note, for example, the British purchase tax which adopts this definition of wholesale value. (See also TAXABLE VALUE.)

**TAXABLE VALUE** — The value upon which various duties and taxes are to be levied. In the case of imports, the taxable value for ad valorem customs duties is generally taken to be the price, either C.I.F. (q.v.) or "F.O.B." (domestic price in country of origin) at which goods are sold, and the rules enunciated in the Brussels Tariff Nomenclature (B.T.N.) (q.v.) represent those which are most widely followed, even among countries which do not yet use the B.T.N. The concept of "value" rather than actual price has to be adopted in certain cases with regard to sales tax, e.g., where goods are transferred from one part of a business to another for internal use or to the proprietor for personal consumption, so that the arm's length, or open market, price is not necessarily charged, and in other instances where the buyer controls, or is controlled by, the seller, or both are controlled by a third person. In practice the tax charge is often related to "value" which is then defined in the tax law as being the open market price, where this price is available, and, where it is not, rules are laid down for determining a value equivalent to open market price. Other instances of the value concept being used as the basis for charging duty or tax include death duties, which are based on the value of assets as at the date of death, wealth taxes upon the aggregate wealth of an individual at specified dates, e.g. each 31 December, and transfer taxes which extend to transfers of assets other than for full cash consideration. (See also TAXABLE PRICE, ANNUAL VALUE.)

**TAXATION AT SOURCE** — A system of tax collection pioneered in the U.K. where the payer of certain types of

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* With the assistance of the staff of the International Bureau of Fiscal Documentation.

income to others was required by law to deduct tax (and account for it to the Revenue) at the STANDARD RATE (q.v.) from the payments, in effect as a prepayment by the recipient of the income who would be credited with the tax deducted.

Deductions were required from interest on loans and mortgages, alimony, ground rents on land, dividends paid by companies and interest on Government securities. The system was extended to tax on salaries and wages by tax deduction schemes culminating in the P.A.Y.E. system; deduction at source, or withholding, is now widely adopted in other countries. See, for example, PRECOMPTE.

**TAXATION YEAR** — Income taxes are normally "annualised", i.e., levied for successive 12-month periods, whereas sales taxes may be levied on a monthly, quarterly or annual basis. Reliefs are given from income tax on the basis of the circumstances of the year when the tax is payable (or of the basis year where this is different). The tax year usually, though not necessarily, coincides with the Government's fiscal year. See also TAXABLE BASE.

**TAXE D' APPRENTISSAGE** — (Belgium, France, Luxembourg) Apprentice tax.

**TAXE LOCALE** — The retail sales tax in France, which was abolished when V.A.T. was extended to the retail level.

**TAXE OCCULTE** — Tax charged upon the incredients or components of an article which is not easy to quantify, and hence difficult to relieve where the goods are exported, represents a "hidden tax" or "taxe occulte". Attempts have been made to relieve such tax when embodied in goods for export, e.g., by EXPORT REBATES (q.v.) and by border adjustments as a means of tax equalisation on imports. The difficulties regarding exports involved have also been tackled in another way, i.e., by adoption of V.A.T. (q.v.). (Note, also, the SANDWICH EFFECT IN V.A.T.)

**TAXE SUR LES ACTIVITES FINANCIERES** — (Belgium, France, Luxembourg) Turnover tax on certain financial transactions.

**TAXE UNIQUE** — In the context of a cascade tax, certain articles of commerce may be specially treated by being charged with a composite tax levied at a single stage and exempted at all other stages of distribution. Such a composite tax is sometimes known as a "taxe unique", but the terms "Forfaitaire" and "Phasenpauschalierung" have also been applied.

**TAXE SUR LA VALEUR AJOUTEE (T.V.A.)** — (Belgium, France, Luxembourg) Value-added tax (V.A.T.).

**TAXFLATION** — Term used in U.S.A. for FISCAL DRAG (q.v.).

**TEILWERT** — This term refers to the system in Federal Germany whereby in calculating income tax depreciation on assets the sale proceeds of an asset may be taken to be a proportion of the sale price of the business where it is sold as a going concern if this figure is less than the WRITTEN-DOWN VALUE (q.v.) for tax purposes.

**TELEVISION ADVERTISEMENT DUTY** — A duty levied in Britain on advertisements inserted in television programmes provided by private sector contractors.

**TELEVISION LICENCE FEES** — Annual fees collected in some countries from users of television sets as a contribution towards the cost of broadcasting programmes by the television broadcasting authority appointed by the government. In the U.K., prepayments by purchase of stamps has recently been revived in respect of television licence fees. Being payable once yearly these fees are a substantial liability for those in lower-income groups who may spread payment by buying special television stamps to fix to the licence renewal application form in due course.

**TEMPORARY ENTRY (IMPORTATION)** — Many countries allow the temporary importation (without levying customs duty and sales taxes) of items which are to be within their borders for only a short time. Examples include motor cars brought in by visitors, including those temporarily employed in the country. Work done in the country by foreign contractors may involve the temporary importation of specialised equipment not available in the country. While some countries allow temporary duty-free import another treatment some times adopted is to charge a proportion of duties and tax based on the ratio of the period the items are employed in the country to the period of the normal working life of the equipment. See also PERFECTION OF ENTRY.

**TENTHS** — A 14th century tax on real property in England charged at the rate of 1/10 of value. (See also FIFTEENTHS.)

**TERMINAL ADJUSTMENTS** — See BALANCING ALLOWANCES AND CHARGES: CESSATION ADJUSTMENTS.

**TERMINAL LOSSES** — Losses in the final year of a business cannot obviously be carried forward because the business has ceased, but some tax codes provide for a carry-back against earlier profits and an offset against other income of the same taxpayer for the same year. In the U.K. and the U.S.A. the carry-back period is 3 years.

**TERMINAL PAYMENTS** — See GOLDEN HANDSHAKE, LOSS OF OFFICE, REDUNDANCY PAYMENTS, SEVERANCE PAYMENTS.

**TERRITORIALITE** — See TERRITORIALITY.

**TERRITORIALITY** — The scope and incidence of a tax is usually related to a particular geographical area, in that residents of that area may be subjected to tax. In addition, assets, income, or transactions located within that territory may be taxed, even though respectively belonging to, or carried out by or on behalf of, non-residents. The territorial concept has relevance, e.g., to income tax, where residents may be taxed on their world-wide income and non-residents on their income that arises within the territory. In the case of death duties the world assets of those domiciled in the territory may be taxed, and the assets in the territory of those domiciled outside it may also be taxed. For sales taxation, tax may apply to transactions taking place within the territory other than exports to customers resident outside the territorial limits. See also SALES AND USE TAXES.

**THERMAL INSULATION** — As in the case of expenditure on fire prevention, safety measures, anti-pollution, etc., the tax treatment of the cost of fuel economy, including thermal insulation, is usually favourable. In the U.K., for example, expenditure on heat insulation in industrial buildings by the person carrying on trade is regarded as equivalent to expenditure on plant and machinery, thus qualifying for CAPITAL ALLOWANCES. See also RESIDENTIAL ENERGY CREDIT.

[to be continued]

# Bibliography

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**BUSINESS OPERATIONS IN ARGENTINA**

By Adolfo Atchabahian. Washington, Tax Management, Inc., 1976. 86 pp.
Guide containing information for doing business in Argentina from taxation and legal points of view. (B. 102.733)

### AUSTRALIA

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By Charles J. Berg. Washington, Tax Management, Inc., 1979. 146 pp.
Guide providing basic information relating to the tax and general legal problems affecting a foreign business conducting its operations in Australia. Supplements will report latest developments. (B. 102.723)

**TAXATION IN AUSTRALIA**

International Tax and Business Service. New York, Deloitte Haskins & Sells, 1979. 87 pp.
Comprehensive outline of taxation in Australia. After an introduction to the tax system, income taxes and other taxes are covered. (B. 51.570)

### AUSTRIA

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**INVESTMENT AND TAXATION: AUSTRIA**

London, Touche Ross International, 1979, 29 pp.
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Brochure providing basic information for businessmen doing business or investing in Brazil from general legal, business and taxation points of view. (B. 15.983)

### CANADA

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By Robert Couzin. Washingtan, Tax Management, Inc., 1978. 135 pp.
Guide providing general information to enable U.S. businessmen to understand the commercial and tax law problems arising from business dealings with Canada. (B. 102.715)

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### ECONOMIC STATISTICS FOR THE PEOPLE'S REPUBLIC OF CHINA 1977-1978 AND CHINA'S NATIONAL BUDGET AND ECONOMIC PLAN FOR 1979

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### THE HONG KONG AND SHANGHAI BANKING CORPORATION

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### REPORT FROM THE COMMISSION TO THE COUNCIL ON SCOPE FOR CONVERGENCE OF TAX SYSTEMS IN THE COMMUNITY

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No. 27, July 1980. Paris, Organisation for Economic Co-operation and Development, 1980. 157 pp. (B. 102.745)

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By Stanley F. Rose. Washington, Tax Management, Inc., 1979. 105 pp.
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By Barry A. Woods. Washington, Tax Management, Inc., 1979. 222 pp.
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Received between August 1 and August 31, 1980

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# CUMULATIVE INDEX 1980 - Nos. 1-10

## I. ARTICLES

# Conference Diary

## DECEMBER 1980

*Institute for International Research:* Asian Property in the 80's (including: Hong Kong tax and related accounting implications of property transactions; Taxation of property profits in Singapore and Malaysia), Hong Kong (Hong Kong), December 1-3 (English).

*Management Centre Europe:* International cash management (including: International tax aspects in cash management), London (United Kingdom), December 8-10 (English).

## JANUARY 1981

*The Economist:* Joint ventures in China (including: Some practical tax case studies), London: January 29; Zürich (Switzerland): February 2 (English).

## FEBRUARY 1981

*Management Centre Europe:* International Tax Management (including: Inter-company pricing: licensing, service fees) (Seminar), Brussels (Belgium), February 12-13 (English).

## MARCH 1981

*Management Centre Europe:* Managing and Developing Foreign Subsidiaries (including: Tax in international operations), Brussels (Belgium), March 4-6 (English).

## APRIL 1981

*Management Centre Europe:* Fourth MCE International Tax Conference. Chairman: Prof. J. van Hoorn Jr., Co-Chairman: A.G. Davies C.B.E. Main subjects: Transfer pricing; Government and business views on tax avoidance; Taxation of international leasing; small meeting groups directed by members of the faculty, Munich (German Federal Republic), April 8-10 (English).

## SEPTEMBER 1981

*35th Annual Congress of I.F.A.:* I. Mutual agreement procedure and practice; II. Unilateral measures to prevent double taxation, Berlin (German Federal Republic), September 21-25 (English, French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

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# Contents

of the December 1980 issue

National Meeting of the U.S.A. Branch of IFA, January 17 & 18, 1980.

# New Developments in Tax Treaties

*On January 17 and 18, 1980 the U.S.A. Branch of the International Fiscal Association held its fourth annual meeting in Philadelphia, Pennsylvania. The technical discussions focused on new developments in tax treaties and were co-chaired by Mr. Chester C. Hilinski, executive vice-president of IFA, and Mr. Robert J. Patrick, vice-president of IFA.*

*As in the past,*[1] *the U.S.A. Branch of IFA requested the Editors of the* Bulletin *to publish a number of papers read at the annual meeting. The Editors, considering these papers of particular import for an international readership, are pleased to comply with this request and they wish to congratulate the U.S.A. Branch of IFA on finding so many highly qualified speakers, not only from the United States but also from Canada and the United Kingdom, to discuss a number of subjects which are currently of interest.*

*The first subject,* estate and gift tax treaties *discussed by Mr. Sanford H. Goldberg, is not only a rare subject for IFA, as the speaker remarked, but also a topic on which not much recent literature exists. Mr. Goldberg analyzed the existing U.S. treaty network as well as the OECD and U.S. Model Conventions. He also mentioned pending legislation which will subject to U.S. tax foreign taxpayers holding U.S. real estate through a corporation, a subject which was touched upon by a number of other speakers.*

*The subject of* tax havens *featured two speakers, Mr. M. Carr Ferguson, assistant attorney general, and Mr. Richard A. Gordon, a representative of the Internal Revenue Service, who described possible measures to combat tax evasion through the use of tax havens.*

*Professor Stanley S. Surrey's talk on the United Nations Group of Experts and the LDC Model Treaty* has not *been included in the set of papers published in this issue of the* Bulletin *as Professor Surrey's extended discussion will shortly appear in the series "Selected Monographs on Taxation", which is a joint venture of the Harvard Law School and the International Bureau of Fiscal Documentation.*

*The subject of* tax treaty interpretation *was represented by three papers: one by Mr. David Rosenbloom of the United States and two by Canadian tax experts, Mr. David A. Ward and Mr. Nathan Boidman. Mr. Rosenbloom, who is a U.S. treaty negotiator and also an international tax counsel to the U.S. Treasury, formulated a number of questions and tentative answers thereto, focusing on issues such as who does the interpreting, what type of law is a tax treaty and which materials will be relevant in a given case. Mr. Ward expressed his views on the Canadian tradition in the field of tax treaty interpretation, giving a survey of some well developed principles of public international law which may have a bearing on tax treaty interpretation. The reader will not find Mr. Boidman's views on this subject in the present issue, as we published his paper in the combined August-September 1980 issue of the* Bulletin *which was distributed at the Paris IFA Congress in September 1980.*[2]

*Mr. Marshall J. Langer and Mr. David Brockway treated the subject of* overriding of tax treaties by ordinary legislation, *a subject which may be of particular interest and perhaps also surprise to non-U.S. readers who live in countries where it has been firmly established that tax treaties always take precedence over ordinary legislation.*

*Mr. J.F. Avery Jones, a solicitor from the United Kingdom, discussed* mutual agreement provisions, *a subject that introduces one of the main themes at the 1981 Congress in West Berlin. The focus of his narrative was on the binding force of mutual agreements for the tax authorities as well as for courts.*

*Finally, Mr. Robert J. Patrick and Mr. Paul T. McDaniel analyzed* source rules, *a subject that was discussed at the 1980 Paris Congress of IFA. A summary of these IFA proceedings can be found on page 564 of this issue.*

1. See *Exploration of Income Tax Treaty Policy Issues in the United States* (National Meeting of the U.S.A. Branch of IFA March 15 and 16, 1979) in 34 BULLETIN FOR INTERNATIONAL FISCAL DOCUMENTATION 52 (February-March 1980).
2. *Interpretation of Tax Treaties* by Nathan Boidman in 34 BULLETIN FOR INTERNATIONAL FISCAL DOCUMENTATION 388 (August-September 1980).

**Contents**

# Modern U.S. Estate and Gift Tax Treaties

by Sanford H. Goldberg*

The topic I am going to discuss is estate, gift and generation skipping taxes. It is a rare topic for IFA. At the last IFA meeting in Copenhagen, the problems of the closely held corporation and wealth transfers were discussed. The only time that IFA has discussed the subject in all of its ramifications was back in 1968. Since 1968 the world has changed drastically. Inflation has resulted in estate and gift tax problems for all taxpayers. More importantly, the shift in investment into the United States has produced a major problem for many foreign investors who have decided that the United States is the last bastion of capitalism.

Foreign investment in the United States has increased to such a degree that we are now considering tax laws that would tend to discourage investment in certain areas, whereas in 1966 we were passing laws to encourage investment in the United States. One of the proposals by Representative Fisher would subject to U.S. estate tax shares of foreign corporations that own U.S. real estate. Foreign investors often use foreign corporations as investment vehicles to avoid estate tax.

The estate and gift tax area I will discuss is the treaties. I will not focus on the U.S. tax imposed by the Internal Revenue Code. For those of you who are interested in our statutory provisions, I refer you to an article which I wrote about two years ago, which originally appeared in the *NYU International Tax Institute* and which was reprinted last year in the *Canadian Tax Journal.* [1]

The estate tax treaty network of the United States is relatively modest. Not many people seem anxious to discuss and strengthen estate taxation. Compared to the 28 existing income tax treaties and the number that were discussed today as being in the process of negotiation, there are only about 13 estate tax treaties. I say "about", because I have included in this total our estate tax treaty with Canada. We do appear to have an estate tax treaty with Canada, even though Canada terminated its estate tax in 1972 (without, at the same time, abrogating the treaty). For those of you who are interested in whether the Canadian estate tax treaty is still in effect, I suggest you speak to the Internal Revenue Service and the Treasury. Their answer has been "we don't know", which is an interesting comment since, if they don't know, who should know?

Gift tax treaties are almost non-existent. Other than the treaties that I will be discussing shortly, there are only two gift tax treaties, those with Japan and Australia. Thus, there are no treaties (other than the ones that we will be discussing) which concern our generation skipping taxes. The recent treaties with France and the United Kingdom cover estate, gift and generation skipping taxes and are patterned after the U.S. Model Treaty.

## Prior to 1966 estate tax treaties were situs-oriented

In order to understand our estate tax treaties, one needs a general sense of the historical background. Prior to 1966, the United States negotiated estate tax treaties that emphasized situs. Under these treaties, each signatory country would decide the situs of the asset in question, which would, in the absence of the treaty, be subject to taxation by both countries with no relief. The situs-oriented treaty would frequently permit the imposition of a tax by each country but would provide relief in the form of tax credits for the taxpayer. This approach frequently resulted in a number of problems. One important problem in a changing world resulted from double domicile, i.e. both countries claiming primary jurisdiction to tax without credit for the other's taxes. This was not covered in the old estate tax treaties, which assumed the existence of a single domicile providing a credit to offset the tax imposed in the other jurisdiction. Another problem was the usage of credits, when credits were made available in more than one jurisdiction.

## OECD Draft of 1966

The publication of the OECD Draft of 1966 changed this. It provided an approach whereby taxation could only be imposed on the basis of domicile; and, only in a few situations, would the country of situs be empowered to levy tax. The United States took exception to the most important of the compromises reached in the OECD Draft: the taxation of stock and debt of U.S. corporations exclusively at the place of the taxpayer's domicile. In 1977, the United States published a model estate and gift tax treaty, which was republished and modified in 1979. [2] The above is the background against which the pattern of U.S. negotiations should be considered.

## U.S. Model treaty

The Model treaty of 1977 made a radical departure from the earlier U.S. treaties. It embraced the OECD Draft concepts. Its most salient provisions appear in somewhat different form from the OECD Draft of 1966, as well as from the 1971 Netherlands treaty. Developments subsequent to the Model treaties of 1977 and 1979 with France and the United Kingdom have not indicated any major departures, so that the major provisions of these Model treaties are to be found in the U.K. treaty and the French treaty.

The most recent treaties (I am now talking about the Model (U.S.) treaty, the Dutch treaty, the U.K. treaty and the French treaty) are designed to alleviate double taxation on gifts and estates of United States citizens, domiciliaries and foreign domiciliaries by either limiting the right to tax to the country of domicile or by requiring one of the countries to grant a credit for the tax of the other. In most of these treaties, the country of domicile possesses primary tax jurisdiction, that is, the right to tax estates, gifts and transfers on a world-wide basis. However, under the Model treaty the country of situs is given priority of taxation concerning real property, business assets located in that country, tangible property, ships, aircraft, and partnership interests as well.

The Model treaty also affords a country taxing on the basis of citizenship the right to tax the estate or inter vivos transfers, with a credit allowed for taxes paid to the other state. Generally,

* Roberts & Holland, New York, New York; Washington, D.C.; and Miami, Florida.

1. An updated version will appear in an American Bar Association survey on International Estate Planning to be published shortly.
2. *Editor's note:* see for a reproduction of the text of the U.S. Model Treaty, 33 *Bulletin* 473 (1979).

this is a one-way street, since only the United States still taxes on the basis of citizenship.

### Domicile: a troublesome issue

The most recent treaties also attempt to resolve the troublesome issue of domicile. As was mentioned before, this problem is quite common. It is typically presented by the businessman who leaves his homeland to go abroad to manage an operation in a foreign country and then stays for a number of years. The problem presented is whether the businessman will be taxed in both countries — i.e. in his native country and in the land in which the foreign operation is situated. The problems of double domicile are familiar to most of us here in the United States because of our Federal system, which sometimes results in several states claiming to be the domicile of a given taxpayer. The classical problem involved the estate of one of the principal owners of the Campbell Soup Company. Estate taxes were paid to the states of Pennsylvania and New Jersey because neither state would agree that the other state was the sole domicile and each imposed its own tax. The Supreme Court subsequently agreed with the imposition of tax by both states. We also had the famous Hetty Green situation, involving a dispute between Florida and Texas, where it was not possible to determine which of the two states was the domicile. The Model treaty and the Dutch, French and U.K. treaties differ from our domestic decisional law in that they attempt to solve the problem by finding a single domicile. In my discussion of the way in which treaties deal with the question of domicile, I will approach the problem by focusing on the Model treaty provisions and the departures therefrom which appear in the Dutch, French and U.K. treaties.

### Fictitious domicile

The Netherlands and the United Kingdom have a peculiar concept — a fictitious domicile which continues for a fixed period after a citizen leaves. The period of fictitious domicile is ten years after a Netherlands citizen leaves the Netherlands, while the U.K. treaty and the U.K. capital wealth tax use three years, so that, for three years after an Englishman leaves England, he is deemed to be a domiciliary of the United Kingdom. Our treaties with the Netherlands and the United Kingdom take this concept into account.

Interestingly, the Model treaty preserves the right of the United States to treat as a U.S. citizen for a period of ten years following the loss of citizenship a former citizen of the United States whose loss of citizenship had as one of its principal purposes the avoidance of tax (including the income tax). None of the treaties in force has adopted this provision of the Model treaty. Of course, if the Internal Revenue Service's position in Revenue Ruling 79-152 is valid, then this provision of the Model treaty is superfluous, since the Service will enforce the rule set forth in this provision of the Model treaty even if it is not incorporated in any treaty, or agreed to by any other jurisdiction. As you may recall, Revenue Ruling 79-152 rules that a former citizen is still a citizen and is therefore not entitled to the benefits of any tax treaty. The true question posed by Revenue Ruling 79-152 is whether someone who is not formally a citizen, but is accorded citizenship status within the meaning of the expatriate rules, is a citizen for purposes of those treaties. Like my partner Sidney Roberts, who wrote an article in the October 1979 *Journal of Taxation*, I think that the position expressed by the Internal Revenue Service in this Revenue Ruling is far from accurate, and it creates some continuing problems.

The Model treaty and the treaties with France and the United Kingdom cover the U.S. estate tax, gift tax and the generation skipping tax.

### Gift taxes, potential problems

The Dutch treaty, which was adopted prior to our enactment of the generation skipping tax, only applies to estate taxes. There are very few gift tax treaties, only the two that I mentioned (with Japan and Australia). There has never been much interest in gift tax treaties. A very interesting article about the problem of double and triple or even quadruple gift tax problems, written by one of our panelists, John Avery Jones, appeared in *The British Tax Review* in 1977 with the intriguing title of "Timeo Danaos".

There are at least two principal types of potential tax problems in the gift tax area not effectively dealt with by our present treaty. The first and the easier type to recognize is the imposition of several gift taxes on the same transfer. Gift taxes may be imposed either because a person concerned, such as the donor or the donee, is within the jurisdiction of the taxing state as the result of domicile, residence, or nationality, or because the situs of the property which is the subject of the gift is within the jurisdiction of the taxing state. This problem is intensified when different interpretations are applied by the interested jurisdictions to any of the key terms, domicile, residence, nationality or situs. A simple illustration will call to mind the problems of multiple tax I have noted. Suppose a gift of property that is located in the United Kingdom, which taxes on the base of situs, by a donor who is a citizen of the United States, which taxes on the basis of citizenship. Suppose further that the donor resides in the Netherlands, which taxes on the basis of residence, and that the donee is an individual residing in Germany, which taxes on the basis of the donee's residence. Four gift taxes, the taxes of the United Kingdom, United States, Netherlands and Germany, may be imposed on our hypothetical gift. A bilateral treaty would not resolve all of the problems presented by our illustration. However, meaningful treaty negotiations must try to consider the problem presented by our illustration because it does arise with people having property located all over the world.

The second principal problem of multiple taxation of gifts, which I believe is not covered by our treaty, is the ability to obtain a credit for a gift tax in one country against an estate tax in another country. The Model treaty would require a credit for a prior gift tax in those situations where the United States would grant such a credit under its domestic law. To illustrate the problem, suppose a U.S. donor places his U.K. real estate in a trust in a manner that would be a completed gift for U.S. purposes, but not for U.K. purposes. Later, when the taxpayer dies, the situs of the property is in the United Kingdom. The United Kingdom would impose a death tax based on situs. The question presented is whether in computing the U.K. tax a credit will be provided for the prior gift tax paid in the United States? This is certainly an area that merits attention, and it will probably gain importance in the future.

### Death and gift taxes levied by state or local governments

Another problem not dealt with by our treaties is that presented by the death and gift taxes imposed by state or local governments. This type of problem is dealt with within our domestic regime of taxation. In computing the Federal estate tax, one derives the benefit of a credit for local estate taxes paid which reduces the amount of the Federal estate tax. Unlike the Model treaty, no similar adjustment is made for the local gift and estate taxes of foreign jurisdictions in our treaties with the Netherlands, the United Kingdom and France. Thus, only if there is no local tax imposed in the foreign jurisdiction will the non-resident alien under the treaty receive a full credit in his home country for foreign tax as required by the treaty. This omission is quite serious. The Federal tax rates on foreign estates are much lower than the rates imposed on the estates of U.S. residents or citizens (ranging from six to 30 percent), but the credit for local estate taxes in the United States is based upon statutory rates which were based upon estate tax rates for estates of U.S. citizens or residents, which may be as high as 70 percent. Therefore, the marginal Federal estate tax credit for local taxes may be as great as 16 percent, so that the effect of the estate tax rates would be to reduce the marginal rate of a foreign estate from 30 to 14 percent. Yet, the 16 percent credit is not a windfall, since it will not be available absent the imposition of local taxes of at least that amount. It thus seems inappropriate that foreign jurisdictions are not required to provide a credit for our local taxes — at least to the extent they offset the Federal tax for which a credit is available. It would appear that this is a serious deficiency of the present system. Foreign jurisdictions may have not realized the nature of this problem, or, perhaps, in our negotiations we were at fault in not seeking to assist foreigners investing in the United States by assuring they would not overpay death taxes.

## Multiple domicile

As I have indicated, the most significant feature of the Model treaty, the Dutch, French and U.K. treaties is the adoption of the rule designed to benefit businessmen living abroad under which a citizen of one country who is domiciled in that country can live in the foreign country of his employment without becoming subject to the estate or inheritance tax of the country of employment. The treaties seek to avoid the problem of multiple domicile by applying the rule that one need be domiciled in a foreign country for a certain period ot time before becoming subject to its jurisdiction.

The problems of multiple domicile are caused by a difference in historical approach. The U.S. estate tax is based on domicile, which means physical presence coupled with an intent to permanently reside. In determining the existence of domicile, most European countries do not take intent into account. This poses a problem, since one who was originally a U.S. domiciliary can be physically present abroad for a long period of time, yet make it clear that he always intended to return to the United States. This intent will preserve his U.S. domicile, but it will not prevent the foreign jurisdiction from finding that it had become the place of domicile, as well. The United States' focus on intent in the determination of domicile will not only maintain the existence of U.S. domicile for one absent from these shores, but can also result in acquiring a U.S. domicile with surprising rapidity. For example, an Iranian refugee coming to the United States who says, "I never intend to go back to the Ayatollah. I have moved to the United States and intend to stay here indefinitely", will become a domiciliary of the United States immediately. The Model treaty provides that the taxpayer must be domiciled in the foreign country, if the taxpayer is a citizen of the United States, for at least seven out of the last ten years before the foreign country will obtain primary jurisdiction based upon domicile. If a U.S. citizen lives in a foreign country for less than seven of the last ten years, then he will be deemed domiciled in the United States for treaty purposes.

## Dutch treaty: seven out of ten year rule

The French and Dutch treaties raise an interesting double domicile problem. The Dutch treaty provides that the seven out of ten year rule will apply unless a clear intention to the contrary has been shown (i.e. a person who is a citizen of only one of the contracting states, but would under the applicable criteria be deemed domiciled in both, shall, absent the demonstration of a contrary intention, be deemed domiciled in the country of citizenship alone, if at the time of death he was domiciled in the other contracting state for less than seven years of the ten year period ending with death). The problem presented is that of determining what constitutes the requisite clear intention to the contrary. For example, if a Dutch citizen moves his family to the United States, retains a permanent home in Holland and, at the same time, buys a permanent home in the United States and dies ten years later, he would probably, for treaty purposes, be considered to retain his domicile in Holland for at least seven years of the ten year period. But suppose our hypothetical Dutch citizen also applies for and receives a green card, and, when applying for the green card, says: "I want a green card so I can move easily and travel to and from the United States." Has that green card now resulted in our hypothetical Dutch citizen being deemed, for treaty purposes, to possess a clear intention to remain in the United States, with the result that he will not be deemed to be domiciled solely in the United States for purposes of the treaty?

## French treaty: five out of seven year rule

The French treaty presents the same problem, although the details are somewhat different in that the French treaty uses as a general rule the five out of seven year rule instead of the seven out of ten year rule of the Dutch treaty (i.e. if a person is a citizen of only one of the two contracting states and would, under the applicable criteria, be deemed domiciled in both countries, he shall be deemed domiciled in the country of citizenship alone provided that he was domciled in the other country for less than five of the seven years before his death or the making of a gift and clearly intended to retain the country of citizenship as his country of domicile). It should be noted that this rule is, unlike the rule in the Dutch treaty, applicable to gifts, as well as to testamentary transfers, and, unlike the Dutch treaty, does not presume the existence of an intent to retain domicile in the country of citizenship. The French treaty also provides alternative situations in which the country of citizenship will be deemed the domicile, even absent the requisite intent needed for the application of the basic five out of seven year rule. One of these alternatives is a five out of seven year rule and the other a seven out of ten year rule. Both alternatives to the general rule depend upon the taxpayer having lived in the country which is not the country of citizenship because of the nature of the employment of the taxpayer or the taxpayer's spouse.

## U.K. treaty: seven out of ten year rule

Our treaty with the United Kingdom, like the Dutch treaty, adopts a basic seven out of ten year rule, but uses as the text of residence for this purpose, not residence in the general sense meaning domicile, but, rather, in the manner used for income tax purposes. Residence for income tax purposes differs from the definition of residence for estate tax purposes. In the latter case it is equivalent to domicile.

### Hierarchy adopted by Model treaty

If the above rules do not determine domicile, the Model treaty, following the OECD Draft, adopts the following hierarchy. The individual would be considered domiciled first in the country in which he maintains a permanent home; second, in the country in which his personal and economic relationships are closest to the center of vital interest; third, in the country in which he has a habitual abode; and fourth, in the country of citizenship. (A similar hierarchy is also set forth in the French, U.K. and Dutch treaties.)

If none of the rules afforded by the treaties will determine domicile in a given situation, then both contracting parties must resolve the question through a mutual agreement procedure. It is not clear what happens if they do not agree. Unlike the provisions that deal with mutual agreement where the parties shall consult, this provision of the Dutch, U.K., French and Model treaties simply provides that they *shall* agree on one domicile.

### Habitual abode

The problem with the terms used as the bases for determining domicile, and that John Avery Jones will be discussing in his presentation, is that it is hard to define them with precision, e.g. "habitual abode". Does that differ from a permanent home? Both terms appear in the OECD and the Model treaty and appear to have different meanings. I, for one, am not sure that I understand the difference. Does either term mean a principal residence? Can one, as is the case under the United States' general domestic rules, have more than one habitual abode? The Treasury's technical explanation of the Netherlands treaty states that all of these concepts are highly uncertain in their application and require factual determinations in any particular case, and that these determinations may be extremely difficult to make. More than that, the terms are not terms of art as yet in the United States. Thus, to determine the manner in which these terms will be applied in specific situations may be more in the province of your European counterpart than that of your U.S. consultant.

### Permanent home preceding death

As noted, the French, English and Dutch treaties basically follow the hierarchy noted above, although there are variations. The Dutch treaty follows the Model but requires a permanent home for a period of five years immediately preceding death and does not contain the test of habitual abode. An interesting question of interpretation is posed by the way in which this five year rule is expressed. As noted, this five year rule, which is the first test for determining domicile, requires a permanent home for five years or more immediately preceding death. If the individual in question has moved shortly before his death after residing in one country for five years or more, he would appear not to have satisfied this test with respect to either country, since he has not maintained a permanent home in either country for five years or more immediately preceding his death. Yet, the next text to be applied if the five year rule fails to resolve the issue of domicile, based on a determination of the State with which his personal relations were closest, is based on the individual not having a permanent home for five years or more in either country without specifying when this five year or more period need occur. Although it would appear logical that it need occur immediately prior to death, one cannot be certain, so that if the decedent had a permanent home in the Netherlands for five years, moved to the United States for one year, and then died, it is unclear whether the personal relations test would govern with respect to determining domicile or whether you then have to go to the next test for determining domicile, which is the state of citizenship.

Since the United States is the only country that taxes on the basis of citizenship, the citizen of one of the treaty countries who is not domiciled in his country of citizenship is not specifically covered by the treaties except for residual tax in the United States.

Once the determination of domicile has been made, the jurisdiction of domicile is accorded primary tax rights by the treaties. That jurisdiction can levy tax on all manner of assets. However, the tax to be levied by the jurisdiction of domicile is then modified by situs rules, pursuant to which the country of situs is accorded primary jurisdiction over assets with a situs in that country. Although the country of domicile, as noted, may levy a tax on all assets including those with a foreign situs, it is then required to accord a credit for the tax imposed by the jurisdiction of situs. The situs rules govern the following types of property: real property, business property of a permanent establishment, assets pertaining to a fixed base used for the performance of independent personal services, ships, aircraft and interests in partnerships, owning property to which the situs rules apply.

### Real property

Under the Model treaty, "real property" is taxable by the contracting state in which it is situated. The treaties generally refer to "immovable property" which is defined as real property. In defining real property, the Model and most of our treaties consider mortgages as debt obligations rather than real property. The Model also excludes ships, boats, and aircraft from the definition of immovable property. The answer is less clear for a lease. Under the earlier French treaty, a lease for less than 18 years was excluded from the definition of immovable property implying that leases longer than 18 years are immovable property. The present treaties make no specific provision for leasehold interests, but provide that the determination of whether a given asset is immovable property is to be determined by the laws of the State in which that property is situated.

Real property owned by one who lost his U.S. citizenship shortly before his death poses an interesting problem. Let us suppose that a U.S. expatriate moves to France and retains the ownership of real estate in the United States. Under the French treaty and other recent treaties (though, as noted, the Model treaty has a different rule), it would appear that the United States has lost its taxing jurisdiction even if expatriation is deemed to have been tax motivated, except that the property is deemed situated in the United States and subject to the situs rules. Thus, under the treaty, the United States is accorded the right to impose a tax, with France to grant a credit. That is clear. But the treaty makes no provision relating to the rate of tax the United States may impose. If it was clear that our hypothetical individual was neither a citizen nor an expatriate of the United States, the real estate would be subject to a tax rate ranging from six to 30 percent. However, under Section 2107 of the Code, the United States will tax the real property of a recent expatriate (whose expatriation was motivated by considerations of tax avoidance) at the much higher estate tax rate for U.S. citizens or residents that ranges up to 70 percent. Now, pursuant to the treaty provision, is France required to go along with this? Are they to grant a credit for such an absurdly large tax? I don't know.

## Business assets

The second type of property over which the situs country has primary tax jurisdiction is business assets of an individual's permanent establishment which are located in the situs country and assets relating to a fixed base of an individual, who are used for performance of professional services or other similar independent activities. All of the treaties, i.e. Dutch, French, and U.K., have adopted generally the OECD Draft with respect to a permanent establishment.

There are, however, slight variations: e.g. none of the treaties follows the OECD Draft for a "place of management" within the category of business property of a permanent establishment, although the French treaty does refer to "a seat of management", which may be the same. I am not sure whether this concept can be applied meaningfully for individuals or partnerships. Also, the Model treaty requires the presence of a building site or construction or installation project for more than 24 months if the same is to be considered business property of a permanent establishment. None of our treaty partners has agreed to that. They all have reduced that period to 12 months, which is similar to the period used in the income tax area. In addition, the Model treaty, unlike any of the treaties, treats a drilling rig or ship being used for the exploration of natural resources in the same way as a building site and thus as business property of a permanent establishment. None of the Model or the U.K., French, or Dutch treaties specifically excludes from the definition of a permanent establishment the maintenance of a fixed base used for investment purposes (although, perhaps, investment activities would not be deemed a business and so are, in fact, excluded). It would be inappropriate to apply the permanent establishment concept to a base used for investment for estate tax purposes. Under the permanent establishment, or fixed base, provision, business property may be taxed by the contracting state which is not the place of domicile, if it forms a part of the business property of the permanent establishment situated for treaty purposes in that state. This provision not only applies to property situated in the state where the permanent establishment is located, but also appears to apply to property located outside of that contracting state, and in fact, located within the other contracting partner, except with respect to real estate with respect to which the country of situs has the right to retain its jurisdiction (and ships and aircraft, which are to be taxed exclusively by the country of domicile pursuant to the Model, Dutch and French treaties, though not the U.K. treaty).

The permanent establishment concept poses interesting problems, e.g. if the decedent had a permanent establishment in France, which was the non-domiciliary State, and there was connected to that establishment tangible property in the United States, that property would be attributable to the permanent establishment in France, and, therefore, fully subject to tax by the French government (with a credit against the U.S. tax in the amount of the French tax). The problem is that it is conceivable that an individual or partnership may have more than one permanent establishment just as an individual, as we have seen, may have more than one domicile. If so, how does one decide to which permanent establishment the related property is to be attributed? For example, suppose there are two permanent establishments in different countries and one permanent establishment transfers property to the other and the individual dies when the property in question is neither in France nor the United States. To which permanent establishment will that property be attributed? In other contexts, we use a destination rule to determine the situs of property, but when dealing with a transfer within the same entity, the logic of the destination rule may not be applicable, and it is not clear which rule should govern.

## Tangible personal property

The Model treaty does not specifically cover tangible movable (personal) property, though the French treaty includes that class (excluding currency, personal use property, planes and ships from that category) and renders it subject to taxation by the contracting state in which the property is sited, if the property in question is not taxable by the other contracting state because it is connected to a permanent establishment within that other state. It is not clear what this provision adds to the French treaty, since the United States taxes the property of a U.S. citizen or resident on a world-wide basis so it would always tax the tangible property of a U.S. citizen or resident regardless of where that property was located. The provision, thus, must have been directed toward permitting the United States to tax the tangible property of a French domiciliary situated in the United States. It is odd the French agreed with this provision, assuming my analysis of its effect, but that is about the only analysis I can find that accords with the words in the treaty.

As I noted above, the treaty excepts from the usual movable property rule personal use property. It is by no means clear what personal use property means. For example, we recently had a case involving a foreigner residing in France who kept more than a million dollars worth of jewelry in a vault in the United States. The jewelry was kept here to avoid the risk of moving the jewelry back and forth. On her infrequent visits to the United States, the foreigner took some of the jewelry from the vault and wore it. When she returned to France, the property was returned to the vault. In France she had other jewelry of comparable value to the jewelry kept in the United States (obviously, this was a wealthy individual). Is the jewelry our foreigner retained in the United States subject to U.S. tax because it is tangible, movable property, or is it that type of property that is exempt from U.S. tax as property used for normal personal use of our foreigner. Under our domestic law, jewelry accompanying a person vacationing abroad or in transit is deemed personal property, with a situs where the individual owner has his domicile. Under our domestic rules, tangible property in the situation just presented, which does not accompany the individual and is stored permanently away from the place of domicile, would be treated like real property and accorded a situs at the place where it is permanently stored, so that, if our domestic rule were applicable, it would be subject to U.S. tax.

## Interest in a partnership

The fourth group of property that is accorded a situs under the Model treaty is an interest in a partnership. Under our Internal Revenue Code and the regulations, the situs of an interest in a partnership is not covered. The taxation by the United States of a foreigner's interest in a U.S. partnership would appear to depend on whether the partnership is treated as a juridical entity, and, if it is, whether the entity survives death. If the entity is not respected as a juridical entity following death, then under the Code it would seem to me that one should separately analyse each component of the partnership as one would the property of a sole proprietorship, locating each component where it is sited. This is the rule adopted by the Model treaty. It treats a partnership as an aggregate rather than as an entity. I am not sure whether this would be the rule under the Code. Under the Uniform Partnership Act and the Limited Partnership Act, however, a partnership is an entity so that any interest in it is deemed to be intangible personal property with a situs where the individual owner of that interest is domiciled.

The question is presented as to whether, apart from the Model treaty, the United States could impose a transfer tax on an interest in a partnership in the United States held by a foreigner. If it cannot, then certainly the Model treaty provision should not be able to be more onerous than our local law. Unfortunately, there is no conclusive answer as to how the United States views a partnership interest for purposes of transfer taxation. It is clear that a general partnership terminates upon the death of a general partner, suggesting the absence of an entity, for estate tax purposes. However, even this is of little aid, since most foreigners who invest in the United States do so as limited partners, and when they die, the partnership does not terminate. In conclusion, no conclusive answer can be furnished as to how, given the absence of treaty provisions dealing with the problem, under U.S. estate tax law, the interest of a foreigner in a U.S. partnership will be treated. No decided cases or other authority appear to exist other than the government's asserted position.

## Other property

If the property involved is not real property, business property of a permanent establishment, ships or aircraft (and under the French treaty tangible, movable property not for personal use), then the property may be taxed only by the state in which the decedent donor or deemed transferor was domiciled at his death or at the time of the transfer. This provision covers such things as shares of stock, debts, as well as all of those intangible personal property rights whose status is unclear under the Internal Revenue Code. It does not appear clear to me as to where a patent is located for purposes of the Internal Revenue Code, or, similarly, where the location of a trademark or a copyright is, assuming that these are not attributable to a business or a profession. (An interest in a trust may raise the same type of problem, as well.) As I indicated earlier, I wrote an article about two years ago in which I tried to deal with those problems, and I was unable to arrive at any definitive conclusions.

## Shares of stock

The United States and the United Kingdom have traditionally insisted on taxing shares of stock on the basis of situs, that is, on the basis of the place of incorporation of the corporation, the shares of which are involved. In the OECD Draft, both had reservations concerning Article 8 which would subject shares of stock to taxation by the country of domicile alone. In the Model treaty the United States has retreated from that position and is now willing to treat shares of stock as being taxable solely by the country of domicile.

## Deductions

After it is determined what is subject to tax, the next question to consider is what deductions are permitted. Under the Code, the gross estate of a non-resident alien is limited to the property situated in the United States and only certain deductions are permitted in computing the U.S. tax. Those deductions which are permitted must be allocated. Deductions attributable solely to property not situated in the United States are disallowed. Also disallowed is the portion of deductions not specifically applicable to any U.S. property. The portion of deductions not specifically applicable, corresponding to the ratio of the value of the assets included in the U.S. gross estate to the value of total world assets, will be deductible. These proportional deductions under the Code include funeral and administration expenses as well as general obligations. Certain other types of deductions — the marital deduction and the charitable deduction — are completely denied to the estate of a non-resident alien under the Code, but are granted under the Model treaty.

The deductions permitted by the Code are funeral expenses, other administration expenses, indebtedness, certain death taxes and losses. None of the treaties nor the Model discusses any of those provisions. Many jurisdictions do not allow administrative expenses in determining estate tax. For example, I believe the Netherlands will not. [3] So, unless local law or a non-discrimination provision allows one to secure a deduction for a funeral or administration expense or a loss during administration, one will not be permitted to obtain a deduction in the foreign jurisdiction based upon the treaty. With respect to debts, the Model permits a deduction for a proportionate part of debts corresponding to the proportion of world-wide assets subject to a contracting state's jurisdiction, as well as by debts assumed by the transferee or deemed transferee, and the French treaty allows a deduction for debts allowable in France corresponding to the proportion of world-wide assets taxable by French as well as for debts if specifically applicable to a permanent establishment or fixed base or to ships and aircraft, but only against the value of these specific assets.

The Code rule for claiming deductions may be applicable when the relevant treaty is silent. It should be noted that no deductions are allowed under the Code unless the executor includes all world-wide assets in the Federal estate tax return. Most clients do not wish to include their world-wide assets on form 706NR. They, therefore, generally forego all the deductions including debts. I assume they will continue to forego their deductions under the treaties because they will not wish to disclose world-wide assets.

Under the Code, a charitable deduction is available for all transfers to the United States or any state or political subdivision thereof for public purposes, or to any domestic corporation organized and operated exclusively for religious, scientific or educational purposes (as well as transfers to certain charitable trusts or fraternal orders). It should be noted that, to be deductible, the corporations and associations to which the property is transferred need be organized in the United States and transfers to trusts will only be deductible if used in the United States. It should be noted that if property is located here and the non-resident alien tries to give it to a foreign charity, the amount of the transfer is either fully deductible or totally non-deductible depending upon whether the organization, if a corporation or association, is domestic or, if a trust is involved, whether the property is used in the United States. The deduction is not prorated as with expenses and liabilities.

The other limitations upon deductions applicable under the Code to estates such as filing of a return are also required under the treaties.

The Model treaty will permit a charitable deduction in one jurisdiction for transfers to charities of the other jurisdiction if such transfer would be exempt from tax if made to a similar institution situated in the state levying the tax, and if the foreign jurisdiction in which the institution is situated normally permits a charitable deduction for a transfer to such institution. Neither the Dutch nor the U.K. treaty contains a provision for charitable deductions. The French treaty has a charitable provision, but restricts the charitable deduction to transfers to institutions

3. *Editor's note:* In the Netherlands only funeral expenses are deductible.

which receive a substantial part of their support from contributions from the public or governmental funds. Thus a transfer to a private foundation situated in either jurisdiction would not qualify under the French treaty with the United States.

The marital deduction is not covered in the Code provisions for non-resident alien estates. Under the Regulations, this deduction is specifically denied. The significance of the loss of marital deduction in the United States depends upon whether the property subject to U.S. tax is located in a community property jurisdiction. If it is, the loss of the marital deduction is not particularly important to the taxpayer. If the property is not in a community property jurisdiction, and most states are not, then the loss of the marital deduction could prove significant. In the first Model treaty, the United States granted the marital deduction notwithstanding that in 1966 it reduced its tax rates for non-resident aliens because of the absence of a marital deduction. Thus, even though the reason for not according the marital deduction was the lower tax rates applicable to non-resident alien estates, we were willing to provide a marital deduction for a non-resident alien estate in return for obtaining from the foreign jurisdiction under the Model treaty a 50 percent reduction, up to 50 percent of the value of the property situated in that country, for property passing to the surviving spouse of a United States person. The Netherlands treaty, which became effective in 1971, after the OECD Draft but prior to the first Model treaty, made no provision for a marital deduction to be used in computing the U.S. tax for a non-resident alien; although it did require that the Netherlands provide a marital deduction when dealing with the property of a U.S. person. Both the U.K. and French treaties which were negotiated after the Netherlands treaty provide for a marital deduction in computing the U.S. estate tax on the estate of a non-resident alien. The provisions of the U.K. and French treaties differ with respect to the manner in which the marital deduction will be used in computing the U.S. estate tax on the estate of a non-resident alien. The U.K. treaty requires that the United States accord the marital deduction when dealing with a non-resident alien, while applying the lower rates applicable to the estates of non-resident aliens. The French treaty affords an option. One may in computing the U.S. estate tax for a non-resident alien decedent with a surviving spouse either use the regular rates for a U.S. domiciliary and a marital deduction, or use the rates for a non-resident alien with no marital deduction. The marital deduction provision under the treaties corresponds to the provision of the Code. If one is not entitled to a marital deduction under the Code, if a domiciliary of the United States, one will not secure the deduction under a treaty.

## Exemptions, credits and rates

Under the new unified tax regime, the United States imposes a unified Federal estate and gift tax which is reduced by a single unified credit. However, unlike the taxes for a U.S. citizen or resident, the estate and gift taxes are not uniform for a non-resident alien. Non-resident alien estates are subject to lower rates than apply to the estates of U.S. citizens or residents, as I have already noted. With respect to estate taxes, the rates for non-resident alien estates run from six percent on the first \$ 100,000 to 30 percent on anything in excess of \$ 2,000,000. However, the gift tax for non-resident aliens is imposed at the same rate as for a U.S. citizen ranging up to 70 percent. The generation skipping tax also ranges up to 70 percent, and, as with the gift tax, non-resident aliens deemed transferors are subject to the same rates as apply to U.S. deemed transferors, so that non-resident aliens are not subject to a lower tax rate (as is the case with the estate tax). None of the treaties appears to provide for the reduction by the United States of its rates with respect to gift and generation skipping taxes for non-resident alien donors or deemed transferors. The unified credit under the Code for a non-resident alien is \$ 3,600 for the estate tax. No credit is granted by the Code for the gift tax. The Model treaty does not address itself to a credit for gift taxes, but does grant the estate tax credit of \$ 3,600, or an equivalent exemption in computing the tax otherwise due. Since we no longer have an exemption, it is unclear to me what purpose that provision in the Model treaty serves. What is the effect of the change in our rules unifying the estate and gift taxes replacing the prior estate and gift tax exemptions with a unified credit on treaties antedating this change? Is the estate tax credit applicable against the gift tax as well on the theory that the two taxes are unified? Similarly, whether a similar credit is available under the old treaties against the generation skipping tax is also unclear. The legislative history would indicate that none of the older treaties, when permitting a credit, contemplated that it could be offset against a generation skipping tax (at least one arising under those generation skipping provisions which are analogous to the imposition of an estate tax upon the deemed transferor).

## Relief from double taxation

The Model treaty and our other treaties provide for two credit rules to alleviate double taxation. The first rule is that the United States must grant a credit when it is the country of domicile, and the property taxed is sited under the treaty in the foreign jurisdiction equal to the tax imposed by the country of situs. Situs property consisting of real property, business property, tangible property, ships and aircraft and so forth is property for which the United States must grant a credit. The second rule requires that the United States, when taxing on the basis of citizenship when domicile is elsewhere, grant a credit for the foreign tax. The Model treaty and the treaties with some of our treaty partners provide that the United States when taxing the property of a U.S. citizen not domiciled in the United States must accord a credit for the foreign tax. The normal provision under the Model treaty is that one apportions the credit against U.S. tax for foreign tax based upon the assets located in the foreign jurisdiction to worldwide assets. This would apply both to the situation when the United States taxes on the basis of domicile and when it does so on the basis of citizenship alone. The normal rule also is that the credit accorded by the United States, either when taxing on the basis of domicile or on the basis of citizenship, is to be limited to the pro rata portion of the foreign tax relating to the assets in question. The French treaty contains an exception to the usual rule, which restricts the credit, so that it may not exceed either the amount of foreign tax allocable to the assets subject to double taxation or the amount of U.S. tax allocable to such assets. The French treaty provides, when the United States imposes tax upon property of a transferor or decedent who is a French domiciliary and a U.S. citizen, for a credit in the full amount of the French tax imposed with respect to the decedent or donor in question. If this credit exceeds the U.S. tax allocable to the property in question, the excess is to reduce the U.S. tax applicable to other property in the estate of the decedent or transferred by the donor.

All of the treaties provide for a period of limitations for the purpose of claiming a credit. The Model treaty permits a credit within two years of a final determination and payment, provided that it occurs within ten years of the date of death, gift or deemed transfer. The Dutch, French and U.K. treaties have different provisions. The mutual agreement provisions, of course, may override the normal period of limitation. None of the treaties provides relief from reporting even when no tax is due. The taxpayer cannot make a unilateral determination that his situation comes under the treaty. He must file a tax return. Information exchange is the normal rule, but there are some variations. The one that intrigues me is in the Dutch treaty. The protocol to the Dutch treaty provides that the Dutch will not give us information that is held in a bank or in an insurance company, which means that their bank and insurance company security provisions will govern.

The only treaty that provides assistance in collection is the French treaty. An assistance provision is not found in the Model treaty, but the French have decided that they may need United States' assistance, so they requested the incorporation of that provision in the treaty. It is contrary to the usual U.S. posture.

# Tax Havens

by M. Carr Ferguson *

Haven has alsways been a very pleasant word to me. It suggests solace, respite, shelter, and tranquillity. I know that a favorite definition of a tax haven has been any piece of land not owned by the United States which is above sea level, at least at low tide, and which has no domestic taxes. Unfortunately, I think that the definition, while intended somewhat sarcastically, has come to have some real meaning to many of us. As you know, a Subcommittee on Oversight of the House Ways and Means Committee last April held two days of hearings on the subject of "Offshore Tax Havens".[1] The hearings in some ways anticipated a broader inquiry into what is called the subterranean economy or the invisible economy — that portion of our gross national product or wealth which does not show up on any of the traditional barometers or indices: a barter, cash, faceless, and ownerless economy.

Sandy said in his remarks this morning that we all know that people who own Swiss bank accounts never seem to die (at least that is the case looking at 706's which are filed), and that also is part of the subterranean or at least vaulted economy which is causing increasing concern in Washington. The hearings which were held by the Oversight Committee are instructive, and are worth securing and reading if you have not done so already. They reveal a surprising harmony of views between the private practitioners who presented their views, and the positions expressed by representatives of the Government. Your members Marshall I. Langer, Harvey P. Dale and Joseph H. Guttentag presented testimony; and the Government was represented by officials from the Departments of Justice and Treasury, the Internal Revenue Service and the Securities and Exchange Commission.

The concerns expressed by these witnesses were not substantially different from those articulated in 1962 when the Kennedy Administration initiated the first major efforts to control or regulate offshore tax havens used to shelter overseas income from U.S. taxation. These efforts reflected the continuing tension between our principle that U.S. citizens and residents are taxable on their world-wide income, and the territorial limitations on our ability to investigate and collect taxes. For example, we are all familiar with the provisions dealing with foreign base company income, foreign personal holding companies, and foreign trusts. The success of these provisions in controlling the problem is still open to question, certainly in my mind, and perhaps in the minds of many of you who are more experienced and more sophisticated in the techniques of working around Subpart F or working with Subpart F (maybe that is a more euphemistic way of putting it) than I puport to be.

The growing overlay of treaties and the use of third-country treaties as a way of reducing the tax burden on domestic taxpayers, both corporate and individual, is also a matter of increasing concern. To what extent do the provisions in the Internal Revenue Code and the provisions in our system of treaties produce results which were never intended or contemplated? Here, as in any other area of the law, to the extent that imaginative or aggressive tax planners can develop new ways of utilizing the law and conforming a newly developed kind of transaction to the changing patterns of law, new problems develop.

Another concern is the extra dimension to tax avoidance present in the case of offshore tax havens and other overseas entities. The extra dimension which we do not have in, for example, domestic tax planning without offshore ramifications is that not only can we plan to create a favorable reporting position for a client, we can plan to prepare a position for no reporting at all. More and more wealth seems to be slipping abroad invisibly in transactions which have no significance or purpose in international trade. Perhaps our reporting requirement have not kept pace with the legitimate ingenuity of the private bar and the accounting profession, but I think that this slippage has grown largely due to the creation of questionable devices, techniques, and stratagems for not reporting a transaction.

This lack of reporting has caused a gap between information and belief. This credibility gap is not held by consumers of Government with respect to their Government, but the other way around — a credibility gap held by Government officials with respect to the size of the underground economy or the invisible part of our offshore transactions. This has been reflected in a series of attempts to deal with offshore transactions through the Internal Revenue Code, most recently, I suppose, in 1976 with the draconian changes in the taxation of foreign trusts created by United States persons. But just as that legislation was put into place, we found that it did not adequately solve the problem. Practitioners who previously had been urging establishment of foreign trusts by American citizens are now finding ways to have trusts established by non-resident aliens and then utilized by Americans.[2] Some practitioners are now avoiding the trust format, and are calling entities set up abroad in tax haven jurisdictions foreign foundations or some other entity which seems immune from Section 679. At this point many tax officials have come to the belief that continued amendment of the Internal Revenue laws to try to anticipate and correct a transaction which might give rise to no reporting is almost as fruitless as sifting sand. There must be other attitudes or approaches to the problem.

I think that there is a responsibility not just on the part of governmental officials, but on the part of everyone concerned about the shape of our taxation of international transactions, to suggest and recommend changes in the law which will accomplish what seems to me would be the two principal goals here. First, the policing of investments and transactions which are made by Americans abroad but which have no significant purpose outside the boundaries of this country. Second, the establishment of a series of tax laws which will not impose unnecessary or unrealistic impediments upon the continued growth of a vigorous participation by American investors in international business.

With respect to the second goal, it is certainly worth noting the growing concern which some participants in international transactions have that the laws already on the books are beginning to cause problems or place Americans at unfair competitive disadvantages in dealing with investors or businesses in other countries. For example, in the law enforcement area, the problem of

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1. Hearings before the Subcommittee on Oversight of the House Ways and Means Committee on Offshore Tax Havens, April 24 - 25, 1979.

2. This type of transaction was the subject of Rev. Rul. 80-74, I.R.B. 1980-11, 13, where the Service ruled that the double trust was a sham and taxed it as a grantor trust.

bank secrecy has brought the goals of the investigator and commerce into conflict. In other countries, as you know, there is a growing pressure to increase bank secrecy. This is frequently referred to as a need to reassure investors, who may otherwise feel their capital should be moved to another country, that they will be protected if they keep their bank deposits or other passive investments in a country which has traditionally provided secrecy. American banks both here and in their branches abroad are concerned that if they cannot offer similar confidentiality they will tend to lose their ability to pool capital.

Partly to ameliorate this concern of American banks, Congress in 1978 enacted the Right to Financial Privacy Act.[3] The statute has not totally alleviated the banks' interest in having additional protection as to the identity and size of deposits. On the other hand, law enforcement officials repeatedly suggested during the April 1979 hearings[4] that the Treasury step up its activity with respect to currency transaction reports required of banks in this country. So I think this will be a point of conflict with respect to bank transactions; certainly, until we are all using nothing but universal credit cards, cash will continue to be amoral and at times untraceable and the problem will remain with us.

These are some of our problems and concerns. What should be the avenue of our attack on these problems? Certainly as the traditionally high level of taxpayer compliance and taxpayer morale (which is sometimes described as the best in the world) is threatened by what is perceived as a growing tendency to use tax havens and to engage in transactions lacking any significant purpose other than the reduction of taxes, there will be pressure to make use of both existing weapons and to create new weapons. This country probably takes tax evasion and tax crimes as seriously as any country in the world. That is no less true of tax havens. It is not surprising that when a part of our system seems to be particularly under siege, the instinct on the part of Government officials is to roll out heavier and heavier weapons to confront the problem. The problem here is the fact that non-resident alien entities are not subject to our tax or reporting requirements, and one of the heavier weapons which has been suggested from time to time has been the criminal law dealing with tax evasion.

It seems to me rather obvious that over-reaction by the Government to a problem is not necessarily useful. This is a good example. In a sense, using the criminal statutes with respect to tax evasion and the filing of false documents as a way of controlling what is perceived as the abuse of the laws of tax haven jurisdictions or the utilization of tax haven entities to abuse our own domestic income tax is a little like using cannons to control a mosquito problem. It is ineffective and out of proportion. One cannot end tax manipulation or efforts to reduce taxation, to below an acceptable minimum, by trying to terrorize the lawyers or other tax planners who counsel such transactions. What is needed is across the board increase in the level of intelligence — I don't mean I.Q. — but rather information developed by the Internal Revenue Service.

However, having said that, I think that the criminal laws have played and will continue to play an important role in buttressing taxpayer compliance. Offshore trusts and similar entities used to evade federal taxes are frequently undertaken after seeking rather probing and sophisticated advice from a tax professional. The reliance on the advice of tax counsel is a pretty good defense in any tax evasion suit. Almost unavoidably the focus of attention is then drawn to the tax advisor: is the advice given within the bounds of what is acceptable, or at least within the bounds of what is not criminal; or has the advice strayed beyond that boundary so that it should be characterized under the criminal laws as participating and assisting in the filing of a false document, namely the tax return?

The application of the criminal laws to tax counselors has been tested in recent years in two celebrated cases against tax lawyers who counselled series of transactions involving offshore havens. The results of those cases have not been conclusive one way or the other. All three cases were tried before juries. In one of the cases a jury acquitted the lawyer; in another case the jury convicted the tax lawyer; and in the third case involving two tax lawyers, the jury acquitted one and convicted the other. Juries being as inscrutable as their reasons, it is rather hard to know to what extent the juries weighed carefully or analyzed the boundaries between aggressive tax planning and outright fraud. But certainly there were badges of fraud alleged by the Government in all three cases: for example, the backdating of documents, the creation of documents to describe transactions which never occurred, and the intentional suppression of information required by the returns at the time they were filed. A mere substance versus form kind of argument, nothing more, hardly seems the basis for a criminal prosecution. Indeed, cases have not been brought as far as I know either against lawyers, other counselors, or their clients, where some fairly obvious and I think generally disapproved badge of fraud was not present.

One problem is that the lack of complete reporting, the lack of mechanism for filing a return with respect to the offshore entity in a tax haven, makes it difficult at times for those counselling a client to utilize the usual defense of attaching a rider to the return explaining what happened. I suggest, however, that at least with respect to the domestic part of such a transaction it is usually possible to find a return — say a return claiming a deduction with respect to a transaction which is known to be with a related offshore entity — and to attach the rider at that point even though the offshore entity itself need not file.

I also think that the disclosure problem, to the extent it exists, can be solved by better attention to the reporting forms required with respect to the establishment of an offshore entity in which an American taxpayer has a beneficial interest of a sufficient percentage. The impression which I have, and which I think many of you may share, is that those forms are not filed regularly; to the extent they are filed, as far as many people can tell they are not inspected very carefully by the Internal Revenue Service.

As I say, I think that the use of tax haven jurisdictions for transactions which really have no economic significance either in the tax haven or in a third country does not merely constitute a law enforcement or definitional problem on the civil side; it constitutes a problem for everyone whether in the Government or in private practice. As long as such problems continue or increase, the likelihood is that we will continue to see Congress periodically tightening up the tax law in ways which will penalize not those who engage in the transactions which should be the subject of corrections, but penalize others who are very conscientious in terms of their reporting requirements and in disclosure.

The targets of our investigation and prosecution have not stopped with American taxpayers and their advisers. In fact, a former Bahamian banker and a former Caymanian banker are presently fugitives from justice on criminal charges which were returned against them for participating in schemes with respect to which the United States participants have already been tried and convicted. I think that there is therefore a sense that our problem is one that involves evidentiary problems which are sometimes beyond the power of the federal courts to resolve, or beyond the power of the Revenue Service to fully grasp. And certainly, we have seen cases referred from the Revenue Service for prosecution which no doubt were solid and correct in theory but which were incapable of prosecution because of the inaccessibility of key overseas witnesses. We continue to have a group of specialists within the Criminal Section of the Tax Division working on offshore tax crimes, or tax crimes which have offshore aspects. Some of the conclusions which were drawn about the future success of those cases are rather fully set out in the hearing of last April to which I have directed your attention. I might just say, however,

3. P.L. 95-630, 92 Stat. 3541.
4. See note 1, supra.

that there are a couple of rather common aspects of those cases. First, in most of them at least 90 percent of the necessary evidence is available within the United States. Second, the fact that a tax crime has been committed is so much more difficult to uncover where a missing party to the transaction is not seen in returns filed in this country, that in many of the cases ultimately referred to us for prosecution civil audits have already been completed without any uncovering of the crime. That means that very frequently the triggering event which prompts consideration of criminal prosecution is the development of information outside the usual civil audit technique — informers, competitors, or an investigation starting outside the tax area.

We shall continue to develop leads and techniques of this type, not just because of the Congressional prompting at the hearing last April, but because of a growing concern generally about the invisible part of our economy. Both the Department of Justice and the Internal Revenue Service will be devoting redoubled efforts to uncovering and prosecuting criminal abuses of present tax laws dealing with international transactions. Perhaps one of the clearest pieces of evidence of this new concern has been the establishment of a Special Commission headed by Dick Gordon to ferret out all the kinds of abuses, to make some estimate for us of the extent of the problem, and to recommend to the Government methods of dealing with the problem. Jerry Kurtz and I are very happy to have had Dick agree to head up this Special Commission, particularly since he comes from outside of the Government. We hope that he can investigate information available in the Departments of Treasury and Justice and in the Internal Revenue Service, and then give us a fresh evaluation of our old methods of dealing with these problems. I believe your organization shares a common interest with us in pursuing this study, so as to ensure the appropriate use of tax haven jurisdictions. I hope you can work with us and with the Congress to develop more effective ways than we have today of policing these problems.

It has been a pleasure to describe to you our concerns and problems, and to lay out broad avenues of attack. I hope that the next time someone from the Department of Justice is invited to speak, he will be able to tell you the effective results of Dick's study and to assure you that we are on the way not simply to realizing what the problems are, but also to solving them.

# Impact of Tax Havens on the U.S. Tax System

by Richard A. Gordon *

At the direction of Commissioner Kurtz and Assistant Attorney General Ferguson, we have put together a study group to examine the impact of tax havens on the U.S. tax system. Congress likes us to study things and so we called it a study group. It is made up of employees of the Internal Revenue Service. Also, certain employees of the Tax Division are working with us, and we are getting significant cooperation from David Rosenbloom's office. The best thing I can do this afternoon is to spend five or ten minutes telling you what it is that we will be doing.

Conclusions are premature. I concur in Carr's wish that the next time somebody from the government comes here to speak, they will tell you about all of our conclusions and how successful we have been in acting on them.

When I took this job, I was somewhat skeptical as to the extent of the problem. A lot of strange schemes had been described to me, and there were rumors about large amounts of money flowing to tax havens. My skepticism evaporated when I started receiving brochures from practitioners in the field. Initially these came from California. Very strange things always go on in California anyway, so I disregarded them; but then they started moving east. I thought maybe one example would be very useful.

This is one example of many of these kinds of things we have seen which rely on the foreign trust which we thought we had dealt with in 1976. The promotion guarantees that your life can be 100 percent free of capital gains tax, 85 percent free of tax on ordinary income (and before you think that the 15 percent tax is grounds for malpractice, they say that this tax can usually be sheltered), 100 percent free of probate tax and red tape, 100 percent free of gift tax, and 100 percent free of inheritance tax. You can also avoid state sales tax on big ticket items, and avoid cross-liability which is where assets are protected from personal legal liability. The trusts are ready to use, they are legal, they are guaranteed by the U.S. Constitution, at least so the publicity brochures say. The fee for this, well, $ 15,000 was quoted in one or two brochures I have seen, and the brochures claim it is deductible. You might wonder how you get your money out so that you can continue to live. They allow appointments of privileged recipients who may request tax-free favors; it just goes on and on.

## Purpose of the study group

I would like to tell you what we are going to try to do. As Carr pointed out, the government is having a lot of problems and in some areas some think that we are totally incapable of dealing with this epidemic. I am not sure that that is exactly true, but I think we are having trouble, there is no secret to that and a study of this area is long overdue. I think that we have recognized that the project is a very difficult one. Even defining the term "tax haven" is very difficult. At the Gibbons hearings the focus was generally on the Bahamas, and the Netherland Antilles and the Cayman Islands, but now we find that Austria adopted bank secrecy just a year ago. This is a serious development because we have an income tax treaty with Austria and I think it is important to find out whether Austria and other countries are still complying with what we feel are their responsibilities under the exchange of information provisions.

Also, any look at havens can be a very broad project because it obviously gets into the whole area of taxation of international transactions. We are going to try to narrow the focus somewhat so that we can get a report out within a reasonable time. We hope to have something by the end of the year. I think that we have people at the top in the tax administration who are very committed to this and that the time is ripe to attempt to do something and we would like to get it done while those people are still concerned about this issue. In the course of his testimony before the Gibbons Committee, David Rosenbloom described what it is that we are going to do. He said that the first step we would have to take, before we decide what to do about tax havens, is to bring ourselves up to the point where we all understand what is happening. That is our first goal. We plan to find out how offshore havens are being used and the ways in which persons who are subject to U.S. tax are using havens to avoid paying tax. We are interested in both the evasion and in the avoidance of U.S. tax.

I think this understanding of what is happening also involves

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understanding what is happening within the Government, and we intend to find out what is happening by undertaking a thorough evaluation of how the tax administrator has reacted to haven problems. We are going to analyze the efforts of the IRS to deal with havens and we are going to examine everything from IRS published positions to the allocation of IRS resources to the investigative techniques that are used in tax haven related transactions by our agents. We are going to analyze the effectiveness of IRS personnel in dealing with tax haven issues. We are also going to look at IRS coordination with other agencies and particularly of course with the Tax Division of the Department of Justice. Obviously Treasury and Justice are two departments that should be able to work very closely together but they have had problems doing so in the past, at least in some cases, and I think that is a serious concern.

We are also going to try to take a look at the substantive responsibilities of U.S. taxpayers and attempt to determine whether and to what extent U.S. taxpayers are complying with those responsibilities and whether or not there are changes in the law which are necessary to enforce those responsibilities.

In this regard we also intend, as Carr indicated, to analyze the reporting responsibilities of U.S. taxpayers and try to determine whether the reporting can be improved. First, to see whether we can get additional information which can be useful to us. Second, to make it clear to taxpayers what there responsibilities are. I think that all of us have had substantial experience in this area and we feel that at least we in general know when a form should be filed. You have people in small towns who rely on accountants and lawyers who have no experience in this area, who frankly do not know what they are supposed to be filing and there are a lot of forms out there and one hope is that possibly we can combine some of these forms and cut down on the number of forms that people need to file.

## Evaluation of tax treaties

When looking at this area we have to look at the treaties and determine what their impact is on the ability of U.S. taxpayers to take advantage of havens. I think that if we find the treaties are a major contribution to avoidance, it may be necessary to reevaluate the program, reevaluate the model treaty. Such a reevaluation is beyond the scope of the present study but certainly an inquiry into the impact of treaties on this problem is not. In looking at treaties we are going to focus on the mutual assistance provision. We will try to find out whether they are working; there is, frankly, some feeling that they do not work well in all cases. You speak to some people in the Internal Revenue Service who have had experience with gathering information and they find out that the quality of information and the ability to get information does not differ from between treaty partners and non-treaty partners, which means that either some of our non-treaty countries are very cooperative or else we are not getting what we should from the treaty partners.

As Carr mentioned, we hope that a good part of this project can be undertaken through discussions with people here, people who are familiar with this area. I have already begun some of these discussions and so far the response has been excellent and I hope that the spirit of cooperation will continue. We would like the problems that are brought forward to be real problems and I think that people with experience who work in the area every day, who have the breadth that the people in this room do, can help us in that regard. We are also going to be talking to foreign tax administrators and try to find out what their problems are and what they have done in the area and try to determine whether there are multilateral approaches that can be taken. In the course of some of those preliminary discussions, we found that other countries are very concerned and a few of them have been even more aggressive on the administrative side than we have.

Finally, we plan to analyze many of the recommendations which have been made, a lot hat were made during the Gibbons Committee hearings, and others which have been made to us. We will also come up with some of our own. I would hope to be able to once again call on many of you for your reactions to some of these recommendations and I hope that these are changes which would enable the Internal Revenue Service and the Department of Justice to better deal with this area.

## Non-legislative recommendations preferred

I would hope that most of the recommendations would be non-legislative. Having had some experience in working with income tax legislation I realize that any time you go up to the hill and make proposals you lose control and things sometimes end up a lot more complex that you intended. Complexity, I think, is part of what leads to the kind of scheme I mentioned to you earlier. It is at times difficult to penalize users of such schemes because all too often the courts have not been willing to find the necessary willfulness to evade tax because things are so complex.

We are also going to undertake a project which I think is the most difficult, which is to attempt to determine the extent of haven use. I think that in part our recommendations have to depend on how large the problem is.

Finally, I also think that we have to focus on the responsibility of the practitioner in this area. In the short time I have been on the job, it has become readily apparent that these kinds of things are very often the product of the overactive minds and the promotional skills of tax advisors. Too often, tax avoidance schemes are backed up by the opinion of counsel. These writers of opinions rely on the very complex nature of the law, and on the fact that the bureaucracy is cumbersome, and even if you catch a few of their clients it takes an awful long time to do it. My hope is that the profession can do something to start policing itself.

# Tax Treaty Interpretation

by David Rosenbloom *

I always appreciate the opportunity to talk to IFA and I particularly appreciate the opportunity to speak on the subject of interpretation of tax treaties, a subject which I have interpreted from my own somewhat parochial viewpoint.

Let me begin by observing that Mr. Ward's very interesting paper and presentation focused upon the question of treaty interpretation in the courts, either implicitly suggesting that the interpretation of a treaty should be precisely the same whether it is undertaken in the context of a litigated case or as presented to the competent authority.

## The issues

One question that I want to raise at the beginning of my statement is, whether there is a difference in interpretation depending upon who is doing the interpreting. This is the other side of a point which Sidney Roberts made in passing, which forms a central question for me; namely, has any power been delegated by the Congress of the United States to the U.S. competent authority to interpret a treaty in a creative way. Another overall issue that I just want to raise, which I think both Mr. Ward and Mr. Boidman really are suggesting, is what type of law does a treaty create — should a treaty be interpreted as statuted, as a constitution, or in some sui generis way. I would like to come back to that question, and just share with you a few thoughts from my own experience as a treaty negotiator in terms of what makes sense. I would put in a footnote at this point; any country which operates with a rule of statutory construction that legislators, in amending the Internal Revenue Code, were aware of everything that was in the Internal Revenue Code at the time of their amendment and took that fully into account is dealing with a legal fiction. Perhaps my experience as a negotiator might lead to a common sense conclusion as to what type of law a treaty creates, but it would not necessarily lead to a legally binding conclusion as to what type of law a treaty creates, because one could indulge the same type of legal fiction on that issue.

A third question besides who is doing the interpreting and what type of law are we talking about is what materials are relevant. I should say at this point that all of these issues are extremely live in my office these days because there is an ongoing, simmering issue which I have reason to believe will surface in one form or another in 1980 in regard to the role of the U.S. competent authority. This is an issue in which my office is intensely interested, much more interested than in the question of how treaties are interpreted when they reach the courts, that being the province of the U.S. Justice Department, hence my reference to my own parochial views.

Finally, a fourth issue that seems to me perhaps not as sweeping as the others, but also relevant, is what is the appropriate procedure for reaching and enunciating a given interpretation of a treaty. That question is not too terribly relevant, in a litigated case, although I can see ways that it might be made relevant. But if you are thinking about interpretation at the competent authority level, I suppose a very important question is the degree to which reciprocity should enter into the substance of decision making.

## Illustration of problems

Now, I realize all of this is highly abstract; so to illustrate the problems concretely, I would like to read to you a very brief provision, paragraph 2 of Article 5 of the income tax convention between the United States and Canada, a convention which could not be more relevant given my Canadian colleagues on the panel today. This provision deals with the taxation of motor carriers. It says, "an enterprise of one of the contracting States engaged in the operation of motor vehicles, as a common carrier or a contract carrier, shall be exempt from tax by the other contracting State in respect of income (if taxed by the former State in respect of such income) arising from the transportation of property for hire between points in one State and points in the other State." An enterprise of one contracting State engaged in the operation of motor vehicles as a common carrier or contract carrier is exempt from tax at source in respect of income arising from the transportation of *property* between points in one State and points in the other State.

The obvious issue is what happens with respect to the income of buses. Now, let us assume, first of all, that the notes reflect absolutely nothing on the reason why the negotiators could conceivably have been prepared to address public transportation only of property and not of persons. Let us further assume that if the question were presented today to any negotiator on either side of the border, that person would not hesitate to reply that the issues should be exactly the same. In other words, do not quarrel with those hypotheses, because I am sure people could invent reasons for distinguishing the two cases. Property is property, persons are persons. If the clause were drafted today, it would include persons and property; and there neither was nor is any policy reason for distinguishing the two cases.

I present that case in the context of what we are talking about now because it is a real case. It is the kind of case that we are encountering regularly, so regularly, that we think we have a serious problem. It is the kind of case that has led us directly into the question of what is the competent authority all about. I suggest, however, that it also has relevance if this type of issue is being considered in the context of a litigation.

## Type of law created by treaty

Now I want to return to my questions. First of all, what type of law does a tax treaty create? It seems clear that from my perspective on the U.S. side of things, a treaty does not create a type of law that is exactly the same as the Internal Revenue Code. It is inconceivable that the treaty negotiators could attempt to resolve every particular case with terminology that would track the language of the Internal Revenue Code; much less that they could spend the time on the variables that arise with respect to each treaty article to achieve the degree of detail that appears in the Internal Revenue Code.

A treaty quite clearly is an attempt to set out principles, and, in that sense, the OECD Model and the UN Model have made

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tremendous contributions to the area, because they have limited the amount of things left open to discuss. The process of negotiation is long enough as it is. Now that we have models that are relatively workable, we have to come to some kind of general understanding of what we have achieved. And what we have, in my view, is a set of principles that are intended to provide guidelines for the resolution of disputes. I would not go so far as to say that an adequate tax treaty is a complete delegation to the administrator, the implementor of the tax treaty, that is, competent authority — simply to resolve cases of double taxation. Obviously, on both sides of any treaty the legislatures and the governments are going to be concerned that there be guidelines. But that is essentially what a tax treaty is; it is a set of guidelines.

### A tax treaty is essentially a set of guidelines

Now, I am always amused when I see courts or anyone else who reads a treaty too literally. But again I call attention to the legal fiction about how Congress acts. I suppose I should be equally amused when the court says the Ways and Means Committee had the full scope of the Internal Revenue Code in front of it when it enacted a new tax provision.

The treaty negotiators, as a practical matter, if they are going to achieve their objective, have to narrow the range of things they are going to talk about. In many cases (and I would say, not completely flippantly, even in regard to Canada), there are language differences among the treaty negotiators. It is hard, given the limits of language, to be sure that we have a true meaning of minds, on the meanings of the operative terms. Even a term that seems simple can have history one side of the border that is completely different on the other side of the border. In short, it is a will-o'-the wisp to assume that the negotiators have reached a complete agreement on all the issues that are going to arise. There has to be some room for play in the joints, some delegation of authority to the competent authority to work out particular problems in accordance with the principles which the negotiators have agreed upon.

In addition to working out particular problems within the ambit of the treaty, there are some unforeseen problems, some mistakes. Take a look back at my buses. We have no history as to why the negotiators of the 1942 treaty left out transportation of persons. Does that mean that the only resolution of the bus problem is for the executive branch to ask Congress for a protocol? — to amend the convention on that issue? If I were in Congress, my reaction would be that the administration proposing such an inconsequential charge would be crazy. There are so many other issues of much more pressing dimensions in the relationship in tax matters between the United States and Canada that it is inconceivable to me that a responsible reviewing body, such as the Senate, would allow the executive branch to try to to correct only one small problem like that. So does that mean we have to live forever with the problem? I repeat that answer. It is a live case.

A tax treaty is designed and intended to diverge from domestic law. There has been a lot of talk about a new generation of tax treaties, that suddenly the tax treaties are cutting loose from the moorings of domestic law and are going off and changing domestic law in ways that were never before changed. To a certain extent, there appears to be some truth to this, when you see an unusual provision such as Article 9(4) of the U.S./U.K. treaty or the efforts to reconcile the U.K. ACT system with the classical corporate tax system in the United States. But it is clear that a treaty is intended to change domestic law on both sides; otherwise, there would be no need for the treaty. In interpreting a treaty, one has to keep that in mind. The negotiators were trying to change domestic law for the purpose of alleviating double taxation and preventing fiscal evasion.

### Relevant materials

Coming back to my second question — what materials are relevant in passing upon my motor vehicle case? It seems that there are two classes of materials that are relevant. I skipped very quickly in my hypothetical by telling you that there was nothing that bore on it, but in order to reach that conclusion, of course, I had to go back hypothetically again, and look at what there was. It seems that the first and obvious place of start is with the treaty language. One has to see whether there is any way of reading the language to achieve what seems to be a sensible result. Secondly, contemporaneous notes of the negotiators on either side of the border would be a prime source material. In the United States, as you know, we convert these notes now into technical explanations at the time the treaties are sent up to the Senate for consideration. The technical explanation or contemporaneous notes would also be a prime source of interpretation. I might add, in that connection, that although not everyone would endorse this view it is my opinion that a technical explanation of the treaty, based on the negotiators' notes would be more relevant on the interpretation of a treaty term than the comments of legislators in the ratification process, and more relevant than the Joint Committee explanation of the treaty.

What is the role of the Senate in the ratification? The Senate is advising and consenting to the ratification of the treaty. It seems, at first blush at least, that the notes of the people who negotiated the treaty are more centrally the statutory history than the Joint Committee explanation. Now, in practical effect there should be no serious divergences because, at least as matters function now, there is a great deal of interchange and there are opportunities for the negotiators to comment upon much of the legislative material. But obviously, there is a potential for divergence, particularily in areas which do not receive a great deal of attention in the ratification process. I spent a good share of yesterday trying to figure out, for example, whether the treaty between the United States and Germany required the Germans to provide exemption for employees of a U.S. Government instrumentality. Most of our present treaties cover both the U.S. government and instrumentalities thereof. The treaty with Germany does not.

What does that mean? One can argue it several ways. Since I think an instrumentality should be treated the same way as the underlying government, I would strive to reach that result. But again, on an issue like that, which is obviously not focused upon in the ratification process, and which may not be focused upon even in the negotiation process, there are opportunities for differences between the legislative materials and the notes of the negotiators.

I would also consider as important primary material in interpreting treaties, the representations made to the Senate in the ratification process by Treasury representatives. It seems that such representations are comparable to the notes of the negotiators. I would also place in the same category the models that are taken into account in negotiations, which today generally include the OECD Model, the U.S. Model, and, if dealing with a developing country, the U.N. Model. I would think that contemporaneous expressions of treaty policy can, in appropriate instances, be important.

Now, there is, however, a second class of less relevant materials which would include, for example, similar language in other treaties. There is a constant strain between the Treasury Department and the Internal Revenue Service on this issue. The Internal Revenue Service of course, is a mass operation. They like treaties to be alike. If the language in six treaties is similar it should be interpreted the same way, even if there were completely different negotiators and the notes are clear that terms were used in different ways. The Treasury wants each convention to be dealt with as a separate deal, a contract, in Mr. Ward's terms, between the United States and the other country. There is a constant tension on that issue.

Secondly, more recent expressions of policy — how relevant are they? Apparently this motor vehicle case, is it relevant to the competent authority, or for that matter to a court, that, if asked today, U.S. treaty negotiators would say that, of course, they would equate the buses with the transportation of property, that there would be no reason for making any distinction between the two types of cases. Is that a relevant consideration in interpreting the treaty? If not relevant in court, is it relevant to the competent authority? That is the kind of issue we are dealing with today.

### Interpretation by competent authority

Now, my third question is, again, who is doing the interpreting? I feel strongly, and I think it is the current view of the Treasury Department, that the competent authority is more than simply exercising a mechanical function sitting there with, in one hand, the treaty and, in the other hand, the Internal Revenue Code, maybe a dictionary, and spinning forth answers as to what words mean. I do not see that as the competent authority function. I would not go quite so far as to say that the competent authority has the right for all treaties to continue negotiations with respect to unforeseen circumstances, that may be too far. There is judgment to be exercised on how far the competent authority can go, at what point it crosses the line, and it becomes necessary to go through the formal steps of negotiating a protocol or a new treaty. But, I believe, and the Treasury believes, that there is room to correct problems under treaties where the words do not precisely fit, where there are strong policies for reaching a particular result.

To spell out a little further the divergence of view on competent authority, one view which I share is that the competent authority has the right and duty to take account of all my primary materials, and that, yes, present policies, present models, any available evidence that will help, can be relied upon legitimately by the competent authority in resolving particular double taxation problems that come up under a treaty. The other side of that coin is that, no, the only things that can be looked at are the treaty language, maybe the contemporaneous notes, the materials submitted in the ratification process, and then one is thrown into the Internal Revenue Code. Now, I can see the reasons why some would be more confortable with immediate recourse to the Internal Revenue Code once that relatively thin supply of primary materials is exhausted. But it is completely unrealistic to believe that treaty negotiators, in fact, have ever or do now negotiate treaties by trying to mesh the terminology used with what is in our Internal Revenue Code in the United States, or the domestic code of any other country. In the first place, now that we are operating on the basis of the agreed models, that is just not right as a starting point. The United States, for the sake of attempting to speed up negotiations, has adopted to a very large degree the OECD Model in dealing with developed countries, and, to a fairly large degree, much of the U.N. Model in dealing with developing countries. The relevant sources of interpretation, once the primary materials are exhausted, are the commentaries on those models to the extent that the United States has not explicitly reserved upon them and — a significant point — to the extent that the commentaries are clear. The OECD Model commentaries, in particular, are not always clear.

### Procedures

Finally, what about procedures? Suppose the U.S. competent authority decides that a particular issue should be decided in a particular way. What does he do then? Does he put out a revenue ruling and wait until the sky falls? We have done that on several occasions. It has not been altogether satisfactory. Do we contact the competent authority of the other side? Suppose the competent authority on the other side says that he does not agree with the U.S. interpretation — is that dispositive of the issue? I would think that there is no good across-the-board answer to these questions, but I feel increasingly strongly that issues of international consequence involving treaty partners should be at least informally cleared with the competent authority of the other treaty country, at least to obtain an expression of their views, and that this procedure should be followed to the extent that we possibly can, given time restraints. I would caution that still leaves a fair amount of slippage in the area of private letter rulings, where, as you know, the Treasury is not involved and, for that matter in many cases, neither is the competent authority.

That concludes my comments. By the way, does anyone know what the right answer is in regard to the buses?

# Principles to be Applied in Interpreting Tax Treaties *

by David A. Ward **

A considerable amount of scholarly legal writing has been done in Canada, Britain, the United States and elsewhere on the subject of international treaties generally and of treaty interpretation in particular. [1] Tax lawyers, accountants and others concerned with interpretation of tax treaties have not, it seems, often dealt with this area of the law, which has been reserved to that small group of specialists, the public international lawyers. This paper, therefore, is intended as a survey for tax practitioners of some of the well developed principles of public international law which may be brought to bear on problems of tax treaty interpretation. The comments are, of course, directed principally to Anglo-Canadian jurisprudential developments rather than to developments in the American courts. [2]

### The treaty: a statute or contract?

The first question which should be resolved in dealing with questions of interpretation of treaties is the determination of whether a treaty is a contract or a statute. A tax treaty originates

* This article has been updated from a paper on the same subject delivered to the Canadian branch of IFA and published by The Canadian Tax Foundation, Can. Tax J. (1977) 263.

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1. See, Ad. McNair, *The Law of Treaties* (Oxford University Press, 1961); D.P. O'Connell, *International Law* (London, Stevens, 1970), 2nd. ed.; McDougal, Lassewell & Miller, *The Interpretation of Agreements and World Public Order* (Yale University Press, 1967); J.G. Castel, *International Law* (Butterworths, 1976), 3rd. ed.; J. Van Houtte, *Principles of Interpretation in Internal and International Law* (International Bureau of Fiscal Documentation, 1968); S. Rosenne, *Interpretation of Treaties, etc.*, 5 Columbia J. Transnational Law (1965), 204; G.G. Fitzmaurice, *The Law and Procedure in the International Court of Justice: Treaty Interpretation and Certain Other Treaty Points*, 28 Br. Yr. Bk. of International Law, (1951), 1; Harvard Law School, *Research in International Law, Part III, Law of Treaties; "Interpretation" of Tax Treaties: The Commissioner's Single Fact Method*, 15 Stan. L. Rev. (1962), 128; J.D.B. Oliver, *Double Tax Treaties in United Kingdom Tax Law*, Br. Tax Rev. (1970), 388; H.K. Lidstone, *Liberal Construction of Tax Treaties — An Analysis of Congressional and Administrative Limitations of an Old Doctrine*, 47 Corn. Law Q. (1962), 529; P. Germer, *Interpretation of Plurilingual Treaties, A Study of Article 33 of the Vienna Convention on the Law of Treaties*, 11 Harv. Inter. L.J. (1970), 400; and J. Hardy, *The Interpretation of Plurilingual Treaties by International Courts and Tribunals*, 37 Br. Yr. Bk. of International Law (1961), 72.
2. As is discussed later, the techniques of treaty interpretation in the

as a contract between two sovereign states concerning taxation or relief from taxation by one state of the residents or citizens of the other. Such treaties typically cover income taxes or estate and gift taxes. Although created through bilateral agreement by the executive branch of government, tax treaties do not come into effect unless appropriate legislation is enacted. [3] Thus, in this sense, a treaty becomes a statute.

Implementing tax treaties by legislation probably follows the Canadian practice adopted by Parliament in 1926, following the recommendations of the 1923 Imperial Conference on Treaties.[4] Whether such ratification is necessary in law is debatable,[5] and recent indications have been given in Parliament that the government believes it has the right to make and bring into force international agreements (not specifically tax treaties) without the prior approval of Parliament. [6] Clearly, to the extent that a tax treaty is at variance with the provisions of the domestic law (e.g. the Income Tax Act), an amendment to the domestic law is a necessary condition precedent to the implementation of the treaty, and this can be effected only by Parliament. [7]

For whatever reason, invariably tax treaties are created, in the first instance, as bilateral international agreements, and are brought into force in Canada as part of the statute law through enabling legislation passed by Parliament. The question is: should such treaties be interpreted by the application of the ordinary rules of statutory interpretation, or should they be interpreted by the application of the rules applied to interpretation of contracts or by some generally accepted rules of international law?

If treaties are properly regarded as fiscal legislation, they should as other fiscal legislation be construed strictly.[8] Where treaties depart from domestic law, they invariably provide an exemption or reduction of tax beneficial to the taxpayer. The usual rule of construction of fiscal statutes, in dealing with exemptions, is to require the taxpayer claiming such exemption to prove not only that his case clearly falls within the exemption but also to convince the court that the exemption clearly applies to the facts of his case. In other words, the exemption is construed narrowly.[9] It could therefore be argued that treaties, if they are the equivalent of statutes, are to be strictly construed.

## Should treaties be strictly or liberally construed?

There is authority, however, that such statutory rules of construction, applicable to fiscal legislation, should not be applied to tax treaties. McNair [10] believes that treaties generally should not be construed in a pedantic spirit and when ambiguous should receive a liberal construction. Van Houtte [11] has expressed the view that tax treaties must be interpreted, in the first instance, by methods similar to those used in interpreting a private contract. It has long been recognized by British courts that a treaty of alliance is not a thing stricti juris but ought to be interpreted with liberal explanations. [12] In interpreting and applying treaties, the courts have said they should be prepared to extend "a liberal and extended construction" to avoid an anomaly "which a contrary construction would lead to". As the court has recognized that "we cannot expect to find the same nicety of strict definition as in modern documents, such as deeds, or Acts of Parliament; it has never been the habit of those engaged in diplomacy to use legal accuracy, but rather to adopt more liberal terms". [13] Canadian courts have established that:

*"The accepted principle appears to be that a taxing Act must be construed against either the Crown or the person sought to be charged, with perfect strictness — so far as the intention of Parliament is discoverable. Where a tax convention is involved, however, the situation is different and a liberal interpretation is usual, in the interests of the comity of nations."* [14]

The English courts have also recently confirmed this principle of a liberal interpretation of international treaties. In referring to the construction of a British statute which implemented an international treaty to which Britain had become a party, Lord Macmillan said:

*"It is important to remember that the Act of 1924 was the outcome of an International Conference and that the rules in the Schedule have an international currency. As these rules come under the consideration of foreign Courts, it is desirable in the interests of uniformity that their interpretation should not be rigidly controlled by domestic precedents of antecedent date, but rather that the language of the rules should be construed on broad principles of general acceptation."* [15]

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Canadian system have departed significantly from principles of statutory interpretation, in part embracing techniques which American courts would routinely use in interpreting statutes but which have been avoided in the Anglo-Canadian system.

3. Vanek, in his article *Is International Law Part of the Law of Canada*, 8 U. of T.L.J. (1949-50), 265, states that a treaty that affects private rights requires ratification of Parliament. He further suggests that a treaty made by the federal executive branch could, if it affects a branch of law in which the provinces have jurisdiction, be implemented by provincial legislation. See too: *A.G. Can. v. A.G. Ont. (Labour Conventions Case)*. [1937] A.C. 326 and *Arrow River v. Pigeon Timber Co.*, [1932] S.C.R. 495, rev'g. 66 O.L.R. 577, rev'g. 65 O.L.R. 595, and the Canadian Government Memorandum of July 21, 1952, published in the United Nations Legislative Series, Laws and Practices Concerning the Conclusion of Treaties, ST/LCO/SER.B/3, 24 and 25. The federal government takes the position that it has the exclusive power to make international agreements: Hon. P. Martin, *Federalism and International Relations*, Queen's Printer (1968), 11-16, 24-28 and 30-33. However, the power of the provinces to make treaties in areas of law in which they have jurisdiction has received judicial approval: *Re Reciprocal Enforcement of Maintenance Orders Act*, [1956] S.C.R. 137. *Quaere:* how would an international treaty relating to provincial succession duty or gift tax be implemented?
4. H.C. Deb. (Can.) 1926, Vol. 5, 4758.
5. J.G. Castel, *International Law* (footnote 1), at 31.
6. H. of C. Deb., March 11, 1968 at 7467. As is noted later, most recently ratified Canadian treaties are specifically made subject to alteration, revocation, amendment or replacement by mere Order in Council which is tabled in Parliament rather than by legislation.
7. For a discussion of the legal steps required in the ratification process, see Gotlieb, *Canadian Treaty-Making* (Butterworths 1968), 38-40.
8. *Partington v. A.G.* (1869), L.R. 4 H.L. 100. For a complete discussion of the general rules of statutory interpretation in Canada, see: E.A. Driedger, *The Construction of Statutes* (Butterworths, 1974) and of the specific rules relating to taxing statutes, see C. MacNab, *Equity in Income Tax Cases*, 28 Can. Tax J. (1980), 445.
9. *R. and Provincial Treasurer of Alberta v. Canadian Northern Railway*, [1921] 1 W.W.R. 1178, varied 64 S.C.R. 264, aff'd [1923] A.C. 714.
10. A.D. McNair, (footnote 1) at 217 ff.
11. Van Houtte, (footnote 1) at 42.
12. *The Santa Cruz*, (1798). 1 C.Rob 50.
13. *Maltass v. Maltass*, (1844) Robertson's Ecclesiastical Reports 73 and 76. See also S. Rosenne (footnote 1). However, see Lord Wilberforce in *Buchanan & Co. v. Babco Ltd.*, [1978] A.C. 141 at 153: "*. . . the assumed and often repeated generalization that English methods are narrow, technical and literal, whereas continental methods are broad, generous and sensible seems to me insecure at least as regards interpretation of international conventions.*" It is submitted that this view has been overruled in the more recent decision of the House of Lords in *Fothergill v. Monarch Airlines Ltd.*, discussed infra.
14. RWS Fordham, Q.C. in *Saunders v. M.N.R.*, 54 D.T.C. 524 cited with approval by the Federal Court — Trial Division in *Canadian Pacific Ltd. v. Queen*, 76 D.T.C. 6120 and *Melford Developments Inc. v. Queen*, 80 D.T.C. 6074. In the *Canadian Pacific* case, the court added, "*The parties are in agreement that the terms of the treaty will override the Act and that it should be construed more liberally.*"
15. *Stag Line, Ltd. v. Foscolo, Mango & Co.*, [1932] A.C. 328 at 350 referred to with approval by the Federal Court — Trial Division in *Furness, Withy & Co. Ltd. v. M.N.R.*, 66 D.T.C. 5358 and in *Hunter Douglas Ltd. v. M.N.R.*, 79 D.T.C. 5340 and by the House of Lords in *Fothergill v. Monarch Airlines Ltd.*, [1980] 3 W.L.R. 209. See also *Bulmer Ltd. v. Bollinger S.A.*, [1974] 1 Ch. 401 at 425 where Denning, M.R. said: "*The draftsmen of our statutes have striven to express themselves with utmost exactness. They have tried to foresee all possible circumstances that may arise and to provide for them. They have sacrificed style and simplicity. They have foregone brevity. They have become long and involved. In consequence, the judges have followed suit. They interpret a statute as applying only to the circumstances covered by the very words . . . . How different is this treaty! . . . Seeing the differences, what are English courts to do when they are faced with a problem of interpretation. They must follow the European pattern. No longer must they examine the words in meticulous detail. No longer must they argue about the precise grammatical sense. They must look to the purpose and intent.*"

Therefore, the clear weight of authority would appear to be against using the type of strict interpretation which would normally be applied to an exempting provision of fiscal legislation in construing a tax treaty. The justification for this general rule of interpretation probably lies in the origins of a treaty generally as a contract or agreement between two or more States rather than in its formal ratification by Parliament as legislation. [16]

## General canons of interpretation

In his excellent article, G.G. Fitzmaurice [17] classifies three main schools of thought on treaty interpretations:
(1) *intentions of the parties* or *founding fathers* school;
(2) the *textual* or *ordinary meaning of the words* school; and
(3) the *teleological* or *aims and objects* school.

The author (who at the time of writing was Second Legal Adviser to the British Foreign Office) notes that most cases involve a blending of the three schools of thought, with one of the three schools given primacy over the other two. The author correctly notes that the "teleological" or "aim and objects" school is usually applied to general multinational, social or humanitarian treaties and may not be used frequently in interpreting bilateral treaties such as tax treaties because the parties to bilateral treaties actually work out the specific terms through bilateral bargaining. Multinational treaties are not the result of such a precise bargaining process, and the court therefore has more scope of interpreting treaties by determining their apparent aims and scope. Therefore, in dealing with tax treaties, we are usually concerned with the interplay of two of the schools — the "founding fathers" or "intentions of the parties" and the "textual" or "ordinary meaning of the words" schools. Of the two, Fitzmaurice feels that in interpreting bilateral treaties, the "intentions of the parties" school should be paramount, since according to him it is the juridically natural view derived from well-known principles of private contract law. [18]

## Ordinary meaning of the words

The more conservative view, however, is that the "textual" or "ordinary meaning of the words" theory of interpretation is paramount. As may be obvious, the language used in treaties generally (and tax treaties in particular) does not normally reflect the same degree of precision or detail as one has become accustomed to find in the Income Tax Act. There may be many reasons for this, including the necessity of working with a generally accepted style of drafting which accords with standards of most states. Obviously other states could not likely be persuaded of the advantages of the Canadian style of obscure and complex fiscal draftsmanship. It has been recognized that in construing treaties the court must attempt to give the widest scope to the language in order to include within it all matters intended to be included. [19] The court is bound to construe the words and not wholly depart from them, however, in order to attain the intended or reasonable consequences.

## Courts should give wide scope to treaty language

If it cannot achieve such consequences by construing the words used, it is not empowered to abrogate the treaty merely because its consequences appear anomalous. [20]

It is also clear that the treaty is to be read as a whole, and particular phrases are not to be read in isolation or out of context. [21] In this regard, the natural sense of the words is to be followed, [22] unless perhaps if the result is unreasonable or absurd. [23] If, however, the natural and ordinary meaning of the words is ambiguous or leads to an unreasonable result, then the court should resort to other techniques of interpretation to discover what the parties intended. [24]

## "Travaux préparatoires"

In interpreting contracts between persons in which there are ambiguities, the court may look to other evidence outside the contract for help in finding the intention of the parties. [25] Probably arising from this same principle is the rule of treaty interpretation; the tribunal in interpreting a treaty may consider the "travaux préparatoires" as evidence. [26] The real issue is whether this material can be examined only to confirm an interpretation which is fairly clear from the text itself even in the absence of a patent ambiguity or obscurity. [27] The International Court of

16. See R. Lenz, General Reporter, 2nd Subject, *Interpretation of Double Taxation Treaties*, Cahiers de Droit Fiscal International (1960), Vol. XLII, 299. The co-existence of the rule of strict construction of an exemption provision in the Income Tax Act with the rule of broad construction of a comparable exemption in a tax treaty was confirmed by Thurlow, J. in *Furness, Withy & Co. Ltd. v. M.N.R.*, 66 D.T.C. 5358 at 5363. Note should be taken of the dictum wrongly conceived, it is submitted, of Dumolin, J. in *Western Electric Co. Inc. v. M.N.R.*, 69 D.T.C. 5204, at 5210 "*. . . dealing, as I must, with a measure of exception, expressly enacted by the contracting parties to limit the extent of their own national laws and to devise special rules governing special cases of mutual interest, I feel bound to adhere closely to the current and ordinary meaning of the treaty terms. even more so than to provisions of any other statute.*"
17. See footnote 1.
18. Recent Canadian cases have confirmed that the purposes of a tax treaty, namely, the avoidance of double taxation, should be considered in arriving at an acceptable answer to an interpretative problem: *Hunter Douglas Ltd. v. Queen*, 79 D.T.C. 5340 and *Rutenberg v. M.N.R.*, 79 D.T.C. 5394.
19. *Shahmoon v. M.N.R.*, [1975] CTC 2361. See also Lauterpacht, 28 Harvard Law Review (1935), 564, and para. 1 of Article 31 of the *Vienna Convention on the Law of Treaties*, discussed below. Compare, however, the decision of the International Court of Justice in *Re Peace Treaties of 1947 with Bulgaria, Hungary and Romania*, [1950] I.C.J. Report 221 and *Davis v. Queen*, 78 DTC 6374 (aff'd 80 DTC 6056) where a rather strict, or textual, reading of the treaty was adopted without apparent regard for its underlying purpose.
20. "There is therefore no justification for interpreting the definition so as to distort the ordinary meaning of either word", per Thurlow, C.J., *Queen v. St. John Shipbuilding*, 80 D.T.C. 6272 at 6275. See also, *The Ionian Ships*, (1855) Spink's Prize Cases 193 and *Acquisition of Polish Nationality*, (1923) P.C.I.J. series B, No. 7, 20. This is also illustrated in the judgment of Jackett, C.J. in *Tara Exploration & Development Co. Ltd. v. M.N.R.*, to D.T.C. 6370 at 6377 (aff'd 72 D.T.C. 6288).
21. See *I.L.O. and Conditions of Labour in Agriculture*, (1922) P.C.I.J. series B, Nos. 2 and 3, 23.
22. Dictionary meanings of the words used are frequently used. See, for example, *Western Electric Co. Inc. v. M.N.R.*, 69 D.T.C. 5204; *Bank of Nova Scotia v. Queen*, 80 D.T.C. 6009 and *Queen v. St. John Shipbuilding*, 80 D.T.C. 6272.
23. *Polish Postal Service in Danzig*, (1925) P.C.I.J. series B, No. 11, 39; *Employment of Women During the Night*, (1932) P.C.I.J. series A/B No. 30, 373 and *Arbitration Between Petroleum Development and Abu Dhabi*, (1952) reported Int'l & Comp. L.O. 247, per Lord Asquith.
24. *Admission to the United Nations*, [1950] I.C.J. Reports 8 and *Fothergill v. Monarch Airlines Ltd.* (footnote 15). See for example, *McMahon v. M.N.R.*, 59 D.T.C. 1109 where the Exchequer Court in attempting to give some meaning to the concepts in Article I of the Canada—U.S. Convention interpreted the Article and the word "enterprise" by reference to the presumed sensible meaning as referring to persons and corporations.
25. *Bk. of New Zealand v. Simpson*, [1900] A.C. 182 and *Confederation Life Assn. v. Berry*, [1927] S.C.R. 595. These rules are discussed in Cross, *On Evidence*, 4th ed. (Butterworths, 1974), 546.
26. This was done by the Privy Council in *Molefi v. Legal Advisor et al*, [1970] 3 All E.R. 724. Compare however *Preen v. Simmonds*, [1971] 1 W.L.R. 1381 at 1384.
27. See Fitzmaurice (footnote 1), 5. In contract cases, such evidence, in cases as between parties, may be led only in cases of ambiguity: *Higgins v. Dawson*, [1902] A.C. 1 and *Confederation Life Assn. v. Berry*, (footnote 25).

Justice has been reluctant to have recourse to "travaux préparatoires" where the text of the treaty is clear and leads to no absurdity in the context of the issue.[28] O'Connell seems to feel that no such restriction should apply as to the admissibility of "travaux préparatoires", stating:

*"The primary end of treaty interpretation is to give effect to the intentions of the parties, and not to frustrate them. But as Lauterpacht expresses it, 'the eliciting of the intentions of the parties is not normally a task which can be performed exclusively by means of logical or grammatical interpretation'. Furthermore, the 'intentions' of the parties may never have crystallised or been formulated beyond a certain point. Every lawyer knows that the parties to a contract contemplate only performance: they enter into the transaction with optimism, and do not ordinarily advert to the problems raised by, for example, frustration. The courts pretend that the parties intended what they, the courts, believe they would have intended had they reflected on the matter. It is clear, then, that 'intention' is very often a fiction, and even when there was a conscious intention the words designed to be expressive of it may not be particularly helpful for this purpose. The same is true of treaty intepretation with the added difficulty that the parties may never really have wanted to come to agreement and may have deliberately left the area of operation of the treaty opaque.*

*The problem of treaty interpretation, then, is one of ascertaining the logic inherent in the treaty, and pretending that this is what the parties desired . . . .*

*The term 'travaux préparatoires' is employed to designate those extrinsic materials which had a formative effect on the final draft of a treaty, and which assist to this extent in the disclosure of the parties' aims and intentions. There is little dispute today on the permissibility of resort to these materials by international tribunals, due mainly to the admittedly cautious lead given by the International Court which demonstrated that even single words such as 'industry' are often not susceptible of fixed meaning, let alone expressions such as 'draw up a convention' which might mean anything from presenting a first draft to ratification. The most that the written words can do is set up a presumption in favour of a dictionary meaning, or one devised for application of the rules of syntax. It may be rebutted by the production of preliminary documents disclosing a different intention.*

*From a policy point of view resort to 'travaux préparatoires' is unavoidable. A municipal judge operates within an accepted context of social patterns, and is not open to the criticism of favouring a political position represented by one or other party. An international judge, however, is very vulnerable in this respect, and it is a guarantee both to him and to the litigant States of judicial impartiality if his area of discretion is delimited. Instead of devising a construction to a treaty which is open to alternative interpretations, he has the remedy of discovering exactly what the parties meant by examining their minutes of conferences, their correspondence and their rejected drafts. If objectivity is the aim of judicial construction, it is best achieved by this means. Furthermore, a treaty, unlike a municipal contract, often represents a compromise of vital political interests. To interpret it without reference to the struggle for compromise is gravely to over-simplify the problem of treaty application."*[29] *(footnotes omitted)*

## English Courts

The use of "travaux préparatoires" as an interpretative aid has recently been confirmed as a proper aid for English courts to use in interpreting treaties in *Fothergill v. Monarch Airlines Ltd.*[30]

*"So far as purely domestic legislation is concerned it is well established as a principle of interpretation that, even where the words of a statute are ambiguous or obscure, the proceedings in Parliament during the course of the passage of the Bill may not be resorted to for the purpose of ascertaining what ambiguities or obscure provisions mean . . . . So Hansard can never form part of the 'travaux préparatoires' of any Act of Parliament whether it deals with purely domestic legislation or not . . . .*

*It is, however, otherwise with that growing body of written law in force in the United Kingdom which, although it owes its enforceability within the United Kingdom to its embodiment in or authorization by an Act of Parliament, nevertheless owes its origin and its actual wording to some prior law-making process in which Parliament has not participated, such as the negotiation and preparation of a multinational international convention . . . which Her Majesty's Government wants to ratify on behalf of the United Kingdom but can only do so when the provisions of the Convention have been incorporated in our domestic law . . . .*

*My Lords, it would seem that courts charged with the duty of interpreting legislation in all the major countries of the world have recourse in greater or less degree to 'travaux préparatoires' or 'legislative history' (as it is called in the United States) in order to resolve ambiguities or obscurities in the enacting words . . . .*

*Accordingly, in exercising its interpretative function of ascertaining what it was that the delegates to an international conference agreed upon by their majority vote in favour of the text of an international convention where the text itself is ambiguous or obscure, an English court should have regard to any material which the delegates themselves had thought would be available to clear up any possible ambiguities or obscurities."*[31]

## The Vienna Convention

Articles 31 and 32 of the Vienna Convention on the Law of Treaties[32] (1969) provide that:

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28. *European Commission of the Danube,* [1927] P.C.I.J. Series B No. 14 at 31, *Article 4 of the Charter of the United Nations,* [1947-8] I.C.J. Reports, 63, *Admission to the United Nations,* [1950] I.C.J. Reports 4 at 8 and *Minquiers and Ecrehos Case,* [1953] I.C.J. Reports 47 at 71.
29. D.P. O'Connel (footnote 1), at 262. See also Lauterpacht, *Some Observations on Preparatory Work in the Interpretation of Treaties,* 48 Har. L.R. (1934-35), 575, and van Houtte (footnote 1), at 42.
30. See footnote 15.
31. See also *Hunter Douglas Ltd. v. Queen,* 79 D.T.C. 5340, where the court admitted oral evidence (apparently undisputed) of an officer of Revenue Canada as to the view of the Government concerning the meaning of particular words used in the Canada—Netherlands Income Tax Convention.
32. U.N. Doc. A/CONF. 39/27. May 23, 1969, to which Canada deposited its instrument of accession on October 14, 1970. A memorandum of June 4, 1970 prepared by the Department of External Affairs makes the following statement in respect of the convention:
*"This Convention constitutes a law-making treaty laying down the fundamental principles of contemporary treaty law. Because of the paramount importance of treaties as a source of the international legal obligations binding upon states and the diversity and comprehensiveness of the interlocking network of treaties which today regulate the major part of transactions between states and serve to establish the relationships among them, the Convention must be viewed as virtually the constitutional basis, second in importance only to the U.N. Charter, of the international community of states."*
See Castel (footnote 1), at 912. Rossenne (footnote 1), at 207, outlines the legislative history to Articles 11, 32 and 33 of the Convention.
The Vienna Convention came into force on January 27, 1980 with the deposit of the 35th instrument of accession. The following countries had (at September 26, 1980) signed, ratified or acceded to the Convention: Argentina, Austria, Australia, Barbados, Canada, Central African Empire, Cyprus, Denmark, Finland, Greece, Holy See, Honduras, Italy, Jamaica, Kuwait, Lesotho, Mauritius, Mexico, Morocco, Nauru, New Zealand, Niger, Nigeria, Panama, Paraguay, Philippines, Republic of Korea, Rwanda, Spain, Sweden, Syrian Arab Republic, Togo, Tunisia, United Kingdom, United Republic of Tanzania, Yugoslavia and Zaire. By Article 5, the Vienna Convention applies to treaties which are concluded between States after its entry into force.

**"Article 31**

*General rule of interpretation*

*1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.* [33]

*2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:*
*(a) any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;*
*(b) any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.*

*3. There shall be taken into account, together with the context:*
*(a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;*
*(b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;*
*(c) any relevant rules of international law applicable in the relations between the parties.*

*4. A special meaning shall be given to a term if it is established that the parties so intended.*

**Article 32**

*Supplementary means of interpretation*

*Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of Article 31, or to determine the meaning when the interpretation according to Article 31:*
*(a) leaves the meaning ambiguous or obscure, or*
*(b) leads to a result which is manifestly absurd or unreasonable."*

Even in the absence of the Vienna Convention, it appears that there was no evidentiary rule which would exclude such evidence as "travaux préparatoires" in an appropriate case if an ambiguity exists. [34] It is pointed out that Article 32 is broader than the views expressed by the International Court of Justice and the House of Lords on the use of "travaux préparatoires". Whereas the International Court and the House of Lords restrict the use to cases where the meaning of the treaty is ambiguous or obscure, or where the treaty leads to an absurd result, the Convention permits the use of such material to confirm a meaning established by applying the textual rules of interpretation set out in Article 31. [35] It is doubtful whether a Canadian court would so readily admit such evidence in the interpretation of a treaty which was concluded before January 27, 1980, the date on which the Vienna Convention came into force, in the absence of a patent ambiguity, although it may be required to do so in dealing with the interpretation of treaties concluded after that date. [36]

## Use of OECD Commentary

A specific issue in dealing with tax treaties is thus raised namely whether the Commentary to the OECD Model may be admitted as evidence of the intent of the parties when interpreting a text which follows that of the Model treaty. As has already been stated, when interpreting statutes in the Anglo-Canadian legal systems, the court will not admit evidence of the proceedings in Parliament as an aid to interpretation. [37] It is suggested that Parliamentary proceedings are also inadmissible in interpreting tax treaties brought into force by legislation. However, as evidence of "travaux préparatoires" may be admitted, the Commentary should be also considered as an aid to interpretation, certainly in cases of ambiguity where the treaty has been concluded after the Commentary has been settled and the treaty clause in dispute follows the OECD Model wording, provided, of course, the State whose taxes are in question has not noted any specific observation or registered any reservation to the Commentary. [38] Although it may be a valid argument that evidence of "travaux préparatoires" is not convincing evidence of intention because the best evidence of intention is in the final work, that is to say, the agreement or treaty itself, such an argument does not have much validity in respect of the Commentary which is akin to the minutes of the negotiators of a multinational treaty.

This view is supported by the stated purpose of and use made of the Commentary. As is said in the Report of the OECD Committee on Fiscal Affairs [39] to which the 1977 Model Convention and Commentary are annexed, the Committee believed that it is "*... most desirable to clarify, standardize and guarantee the fiscal situation of taxpayers in each Member country who are engaged in commercial, industrial or financial activities in other Member countries through the application by all Member countries of common solutions to identical cases of double taxation.*" In reference to the earlier 1963 Draft Model and Commentaries, the Committee said, "*The existence of the Draft Convention has made it possible to facilitate bilateral negotiations between OECD Member countries and to reach a desirable harmonization between their bilateral conventions for the benefit of both taxpayers and national administrations. Moreover the existence of the Commentaries has facilitated the interpretation and enforcement of bilateral conventions along common lines.*" On the intended use of the Commentary to the 1977 Model the Committee said, "*As these Commentaries have been drafted and agreed upon by the experts appointed to the Committee on Fiscal Affairs by the Governments of Member countries, they are of special importance in the development of international fiscal law. Although the Commentaries are not designed to be annexed in any manner to the conventions to be signed by Member countries, which alone constitute legally binding international instru-*

33. Article 31(1) has recently been cited in Canada in *Hunter Douglas Ltd. v. Queen*, 79 D.T.C. 5340 and *Melford Developments Inc. v. Queen* 80 D.T.C. 6074 in the U.K. in *Fothergill v. Monarch Airlines* (footnote 15) which also cited Article 32.
34. A consideration of earlier drafts of the treaty as an aid to interpretation has been approved by the Permanent Court of International Justice in *Treatment of Polish Nationals in Danzig*, (1932) P.C.I.J. series A/B, No. 44 at 33. British Courts have also used the technique for at least one hundred years: *Maltass v. Maltass*, (1844) 1 Rob. Ecc. 76, *Porter v. Freudenberg*, [1915] 1 K.B. 857 (C.A.), *Ellerman Lines v. Murray*, [*1931*] A.C. 126. This is permitted by Article 32 of the Vienna Convention and seems also to have support in Canada, see: *Ritcher v. King*, [1943] 3 D.L.R. 553 and *re Noble and Wolf*, [1948] 4 D.L.R. 135. See also D.J. Harris, *Cases and Materials on International Law*, 590, for a discussion of the background positions of the United States, Britain and France to Article 32 of the Vienna Convention. In *Fothergill v. Monarch Airlines Ltd.* (footnote 15), Lord Scarman said at p. 235: "Working papers of delegates to the conference, or memoranda submitted by delegates for consideration by the conference, though relevant, will seldom be helpful: but an agreed conference minute of the understanding upon the basis of which the draft of the article of the convention was accepted may well be of great value."
35. The recitals to the Vienna Convention indicate that the Convention is a "codification and development of the law of treaties". The interpretative provisions have been recognized as a codification of existing law in *Fothergill v. Monarch Airlines Ltd.* (footnote 15). *Quaere:* if the Vienna Convention does more than codify existing principles of international law, does it require enabling legislation to make it effective?
36. As O'Connell (footnote 1), at 253, noted: "It is said that where a treaty clause is clear and unambiguous it does not require to be interpreted. However, it may be doubted if a clear and unambiguous clause has ever been devised."
37. *Lyons v. Wilkins*, [1899] 1 Ch. 255, 264 and *S.E. Ry. v. Ry. Commrs.*, 50 L.J.O.B. 201 at 203 (H.L.).
38. For tax treaties concluded between 1963 and 1977, the commentary to the 1963 Draft OECD Double Taxation Convention on Income and Capital, published by OECD, 1963, might be more appropriate.
39. Published by the OECD, 1977. See pages 5 to 17.

*ments, they can nevertheless be of great assistance in the application of the conventions and, in particular, in the settlement of disputes."*

In preparing the Commentary to the Model Treaty each State is free to record its disagreements with the official interpretation by noting its observations or making a reservation, and of course it is free to depart from the Model Treaty if it wishes to do so in negotiating particular treaty provisions. Therefore, in the absence of a specific observation or reservation by Canada, it is suggested that there is little reason to exclude the Commentary from the interpretative process, even in the absence of a patent ambiguity, particularly so for treaties concluded after January 27, 1980.

## Subsequent practice and exchanges of notes and other documents

Article 31(3) of the Vienna Convention contemplates that in interpreting a treaty there may be taken into account, together with the context, any subsequent agreement between the parties regarding its interpretation or application and any subsequent practice in the application of the treaty. This provision is reflective of a view previously adopted by the International Court of Justice that subsequent practice of the parties to a bilateral treaty is usually a more reliable guide to their intentions than are "travaux préparatoires." [40]

As is noted below, however, unless Parliament has delegated its powers of amending the treaty — and the law arising from the enabling legislation — an interpretation, exchange of notes or other agreement of the parties which goes beyond mere interpretation and which has the effect of amending or adding to the treaty may be ineffective.

## Plurilingual treaties

It is, of course, clear in Canada that both the English and French versions of the treaty are to be given equal weight in matters of interpretation. [41] The question arises: what weight is to be given to the version of the treaty written in a third or even a fourth language?

The answer seems to be contained in Article 33 of the Vienna Convention which provides as follows:

"**Article 33**

*1. When a treaty has been authenticated in two or more languages, the text is equally authoritative in each language, unless the treaty provides or the parties agree that, in the case of divergence, a particular text shall prevail.*

*2. A version of the treaty in a language other than one of those in which the text was authenticated, shall be considered an authentic text only if the treaty so provides or the parties so agree.*

*3. The terms of the treaty are presumed to have the same meaning in each authentic text.*

*4. Except where a particular text prevails in accordance with paragraph 1, when a comparison of the authentic texts discloses a difference of meaning which the application of Articles 31 and 32 does not remove, the meaning which best reconciles the texts, having regard to the object and purpose of the treaty, shall be adopted."*

Article 33 may add little to already established rules of interpretation, since as it has long been the British view that where treaties are drawn up in two authentic versions, Britain could not justify adhering only to the English version. [42]

## Interpretation by reference to the law of the forum

Frequently, tax treaties use terms which may have a special meaning in tax law and perhaps may mean different things in different States. The issue arises in interpreting such bilateral tax treaties: which of the two possible meanings is to govern the interpretation?

When faced with this type of question, the Tax Appeal Board has interpreted the Canada—U.S. Convention in a manner consistent with an earlier decision in the U.S. Tax Court on the same point [43] and the Federal Court—Trial Division interpreted the Canada—Netherlands Convention in a manner consistent with that adopted by the Dutch Secretary of State for finances. [44] The desirability of a uniform interpretation particularly with multinational treaties has been well recognized, but its difficulties are apparent.

*"Unfortunately, there can be no doubt but that at least some of the provisions of these articles have presented difficult problems and have resulted in acutely diverging views in the courts of other States which have adopted the convention. [There are] no less than 30 decisions of various courts, in Belgium, France, West Germany, the Netherlands, Italy and Austria. . . . Those decisions show no less than 12 different interpretations of the provisions of the Convention . . . ."* [45]

Although the present Canada—U.S. Convention does not so provide, the OECD Model states that any term not otherwise defined by the treaty shall, unless the context otherwise requires, have the meaning which it has under the laws of that State concerning the taxes to which the Convention applies. This, therefore, gives the court of the forum the power to interpret undefined terms in accordance with domestic law. [46]

The question remains, however, when looking for the meaning of an undefined term in domestic law, which of various meanings is to be used. In particular, is the term to be defined by reference to its ordinary meaning, or by reference to its meaning in an ordinary legal and commercial sense? If the word has a particular meaning in the ordinary legal and commercial sense, but has a

40. See *South West Africa case*, [1950] I.C.J. Reports 135 and G.G. Fitzmaurice (footnote 1) at 20. For a discussion whether interpretative agreements between competent authorities bind the courts, see J.F. Avery Jones, et al., *The Legal Nature of the Mutual Agreement Procedure under the OECD Model Convention*, Br. Tax. Rev. (1979), 333 at 346.

41. Section 8 of the *Official Languages Act*, R.S.C. 1970, c. 0-2. See *The King v. Dubois*, [1935] S.C.R. 401 and *Irwin v. M.N.R.*, 62 DTC 1356. Some earlier treaties were signed only in the English language and are therefore unilingual.

42. Hardy (footnote 1) at 74. This article thoroughly examines the methods by which the court reconciles the two or more authentic versions, generally adopting that interpretation, if any, consistent with both. If this approach fails, and extrinsic evidence does not resolve the issue, Hardy finds the courts have launched into an inquiry as to which was the original text, giving it greater weight. See *The Standard Oil Co. Tankers case*, (1926) 2 R.I.A.A. 777 at 792. This method of resolving the difficulty was rejected, however, at the time that the Vienna Convention was negotiated: Germer (footnote 1) at 409.

43. *No. 630 v. M.N.R.*, 59 DTC 300.

44. *Hunter Douglas Ltd. v. Queen* (footnote 15). This method of looking to foreign case law was commented upon by Lord Scarman in *Fothergill v. Monarch Airlines*:
*"The decisions of a superior court, or the opinion of a court of Cassation, will carry great weight: the decision of an inferior court will not ordinarily do so."*

45. Megaw, L.J. in *Ulster-Swift Ltd. v. Taunton Meat Ltd.*, [1977] 1 W.L.R. 625 at 631.

46. See those treaties (some of which have been signed only, but are not yet in force) with Australia, Austria, Barbados, Belgium, Denmark, Dominican Republic, Finland, France, Germany, Indonesia, Ireland, Israel, Italy, Jamaica, Japan, Korea, Liberia, Malaysia, Morocco, Netherlands, New Zealand, Norway, Pakistan, Philippines, Romania, Singapore, South Africa, Spain, Sweden, Switzerland, Trinidad and Tobago, and the United Kingdom, all of which contain such a provision.

different or expanded meaning under the Income Tax Act, is the Income Tax Act meaning to be applied to the treaty and, if so, if the Income Tax Act is subsequently amended, does it effectively change the meaning of the treaty? These questions have not been fully answered. First, it should be noted that the OECD wording does not specifically require the application of special meanings of words defined in the domestic taxing statute and the Commentary provides no clarification.[47] Second, it would appear that there has been no general resolution to this question internationally, as in some countries the courts look to the everyday meaning of undefined terms, while in others the courts look to the meaning in the tax legislation.[48] In Canada the position is still open. In *Associates Corp. of North America v. Queen*[49] and *Milford Developments Inc. v. Queen*[50] the Federal Court — Trial Division refused to find that a guarantee fee paid to a non-resident constituted "interest" for purposes of the Canada—U.S. and Canada—Germany treaties respectively. Both treaties had been concluded prior to 1974 when the *Income Tax Act* was amended effectively to deem such guarantee fees to be interest for purposes of the Act. In commenting on the argument of the Crown that the definitions of undefined terms are ambulatory and change with amendments to the Income Tax Act, Mahoney, J. in the *Associates Corp.* case said:

*"The definition of 'interest' in the Protocol is not, by its terms, exhaustive. This is not, however, to say that it can be unilaterally expanded by Canada to embrace income that is not interest at all."*

Clearly, therefore, specific later statutory definitions of treaty terms are not to be used. However, the judge went further and cast doubt on the relevance of an Income Tax Act definition even if made prior to the conclusion of the treaty as he seems willing to accept such a definition only if the provisions of the treaty are worded in such a way as clearly to include guarantee fees in the provisions dealing with interest:

*"I should note that the tax conventions concluded by Canada since its enactment (that is the new definition of interest) in 1974 all contain expanded definitions of 'interest' which may well not be inconsistent with the [new definition in the Income Tax Act.]."*

On appeal, however, the Federal Court of Appeal said:

*". . . we expressly refrain from any finding that a 'deeming' provision in the domestic tax law might not, in other circumstances, be embraced by the provisions of international conventions."*[51]

It has been suggested that where a problem of interpretation arises, other than one of a definition of terms, the application of domestic law should be avoided and the above described rules of interpretation which apply under public international law should be used with a view to obtaining an internationally consistent interpretation of the treaty.[52]

## Interpretation by competent authorities

Article 25 of the revised OECD Draft provides, in part:

*"3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.*

*4. The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of the preceding paragraphs. When it seems advisable in order to reach agreement to have an oral exchange of opinions, such exchange may take place through a Commission consisting of representatives of the competent authorities of the Contracting States."*

The Commentary states that the purpose is to invite the competent authorities to resolve general difficulties of interpretation or application by means of mutual agreement. The view of the OECD is that such mutual agreements should be regarded as binding on the administrators. Although such an agreement may be binding on the administrators, it is questionable whether they would bind taxpayers or the courts. There appears to be no generally accepted view on this question.[53] Although Parliament clearly has the capacity to delegate its power to its own administrative bodies,[54] it is doubtful that a Canadian court would feel bound by such administrative determinations, or find in the language of Article 25 the intention to so delegate.[55] However, the implementing legislation for Canada's recent tax treaties expressly authorizes the Governor in Council by order to amend, revoke, replace or add to such treaties. Clearly, with these treaties the intention to delegate is clear, and administrative agreements as to interpretation may have the force of law if promulgated as Regulations.

## Summary and conclusion

In summary, therefore, there seems to be clear authority that the well developed (now codified in the Vienna Convention) principles of international law relating to treaty interpretation will be applied by the courts in interpreting Canada's new tax treaties. At the present time there is not a large body of well reasoned Canadian jurisprudence dealing with the specific issues of tax treaty interpretation. In light of the large number of new Canadian tax treaties already in force, or signed and awaiting enabling legislation or under negotiation, these issues of interpretation must soon reach the Canadian courts with increasing frequency and such jurisprudence will be developed in the future. The lead in treaty interpretation is clearly shown in the recent United Kingdom jurisprudence and will undoubtedly soon appear in Canada.

47. The 1963 OECD Draft Model was ambiguous, but could be read as requiring a reference to terms as defined in the domestic taxing statutes.
48. See R. Lenz (footnote 16) at 298ff.
49. 80 D.T.C. 6049.
50. 80 D.T.C. 6074.
51. 80 D.T.C. 6140. In light of this statement, the relevancy of Income Tax Act definitions is still open. Compare: *Queen v. Cruickshank*, 77 D.T.C. 5226, where the court immediately turned to the Income Tax Act to find a meaning for the word "pension" but found no statutory definition. However, the word was held to include a lump sum payment out of a pension plan because such amounts were taxed as pensions under the Act.
52. R. Lenz (footnote 16) at 197 and 301. Compare: van Houtte (footnote 1).
53. Avery Jones, et al. (footnote 40) at page 346.
54. *Hodge v. The Queen*, (1883) 9 App. Cas. 117.
55. The treaties with Austria, Barbados, Belgium, Denmark, Dominican Republic, Finland, Germany, Indonesia, Israel, Italy, Japan, Liberia, Malaysia, Morocco, Netherlands, Norway, Pakistan, Philippines, Romania, Singapore, Spain, Sweden, Switzerland and Trinidad and Tobago contain somewhat similar provisions. The treaty with the United Kingdom does not provide so clearly for the competent authorities to make agreements respecting interpretations.

# Override of Tax Treaties by Ordinary Legislation

by Marshall J. Langer *

A number of bills now pending before the Congress are designed to tax capital gains derived by foreigners from their investment in U.S. real property. Three of these bills were former trade bills passed by the House of Representatives: H.R. 1212, H.R. 1319, and H.R. 2297. These bills have marvelous names: The Synthetic Rutile Bill, The Hawaiian Telescope Bill, and the Duty Free Entry of Carillon Bells to the University of Florida Bill. These are trade bills that have passed the House of Representatives, following which the Senate Finance Committee has deleted the entire text of each of the bills, moving the duty-free entry items to other bills. The Finance Committee has substituted entirely new texts that deal, among other things, with the subject of taxing foreigners on capital gains from the sale of real property. These bills were prepared by the staff of the Joint Committee and they were approved by the Senate Finance Committee in December 1979.

Another bill that would also tax foreigners on capital gains from real estate is H.R. 6007, which was prepared by the Treasury Department. It was introduced in December 1979 by Congressman Fisher of Virginia. Most of the bills dealing with this subject provide that any income tax treaty obligation that conflicts with the bills will be overridden after five years. It is likely that some bill dealing with this subject will be enacted during 1980, and it is apparent that both the Congress and the Treasury feel that, in order to be fully effective, this legislation must override existing tax treaty provisions.

## Scope of pending legislation

The Synthetic Rutile Bill (H.R. 2297), for example, would impose a flat tax of 28 percent on capital gains derived by foreign investors from the sale of their interests in U.S. real property. The tax would also apply to gains realized by foreign investors on the sale of shares or other interests in U.S. *"real property holding organizations"*, whether corporations, partnerships, or trusts. A real property holding organization would be defined so broadly that it would include practically every closely-held entity investing in U.S. real estate. The tax would be enforced by withholding provisions, and every real property holding organization would be required to file an annual information return disclosing its shareholders.

## Conflicting treaty provisions

The imposition of such a broadly-based capital gains tax would be in direct conflict with several existing U.S. income tax treaties. Treaties presently in force with Canada and the United Kingdom generally exempt from tax capital gains from the sale of U.S. real property derived by an investor from the other treaty country if there is no U.S. permanent establishment. This may not help in the long run because a new treaty is being negotiated with Canada, and it appears that the final steps toward ratification by the House of Commons of the new United Kingdom treaty are likely to take place by April 1980. When and if the new U.K. treaty takes effect, it will do so retroactively. There will be no further protection as to capital gains since the new U.K. treaty contains no restrictions on taxing such gains.

None of the other existing U.S. income tax treaties contains provisions that would directly protect an investor in real estate. However, several existing treaties do contain provisions that would exempt residents of the other treaty country from U.S. capital gains tax on the sale of shares of a corporation, whether or not the company whose shares are sold is a real property holding organization.

When we review the treaties, we find that the Netherlands Antilles treaty does not contain such a provision. Neither does the old U.K. treaty as extended to the British Virgin Islands. Nor does the treaty with Switzerland contain such a provision. You will find such provisions in the treaties with Sweden, Canada, the United Kingdom (the old treaty for as long as it lasts), the Netherlands (but not the Antilles), Germany, Finland, Belgium, Japan, Norway, Romania, and Poland. We are busily at work now trying to determine how we can make use of Polish holding companies to supersede these new provisions during the coming years.

The Synthetic Rutile Bill provides a special effective date in cases where treaties conflict with the bill. Where no conflict exists, the bill would take effect for sales in 1980 and thereafter. Regardless of any treaty conflict, the bill would apply to sales in 1985 and thereafter.

## Can Congress override treaty provisions?

We come then to the question of whether or not the United States Congress can override an existing treaty by ordinary legislation? And, if it has the power to do so, should it do so in a case such as this? And, if the Congress does choose to override existing treaty obligations, should it give the Treasury five years or some other period of time within which to try to renegotiate conflicting treaty provisions? I am going to try to answer the first question on whether or not the Congress has the right to override an existing treaty by ordinary legislation.

I will leave to David Brockway, of the staff of the Joint Committee, the task of discussing the policy issues that are involved.

It seems clear that the Congress does have the right to enact a law which overrides an inconsistent treaty provision as domestic law, at least if its intention to do so is clearly shown. There is a one-paragraph statement of the law in Revenue Ruling 79—199.[1] Article VI, Clause 2, of the U.S. Constitution states that laws and treaties are the supreme law of the land. Income tax conventions are treaties within the meaning of that supremacy clause under the American Trust Company case.[2] Whenever possible, treaties and laws dealing with the same subject are to be read in a consistent manner.[3] Numerous cases hold that when a treaty and a law are inconsistent, the one last in date will control the other. Thus, when a law conflicts with a later treaty, the treaty prevails; and when a later law conflicts with an earlier treaty, the law prevails.

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1. 1979—1 C.B. 247.
2. American Trust Company v. Smyth, 247 F.2d 149 (9th Cir. 1957).
3. Head Money Cases, 112 U.S. 580 (1884).

*"The purpose of a law to override all or part of a treaty will not be lightly assumed. It should appear clearly and distinctly from the words used in the law."* [4]

There is a good summary of the existing law in the Restatement Second of Foreign Relations, Section 145, which says that *"an Act of Congress enacted after an international agreement of the United States becomes effective, that is inconsistent with the agreement, supersedes it as domestic law of the United States if the purpose of Congress to supersede the agreement is clearly expressed"*. The Restatement adds that the superseding of the agreement as domestic law of the United States by subsequent Act of Congress does not affect the international obligations of the United States under the agreement.

The Internal Revenue Code contains two provisions dealing directly with the relationship between the Code and Treaties. Code Section 7852(d) states that no provision of the Code shall apply in any case where its application would be contrary to any treaty obligation in effect on the date that the Internal Revenue Code was enacted. That date was August 16, 1954. That provision was apparently included to prevent the enactment of the 1954 Internal Revenue Code from taking precedence over all pre-existing treaties on the ground that it was a new Act of Congress. Since it was later in time it might otherwise be deemed to override the pre-existing treaties. One of the interesting aspects of the section, however, is that it continues to apply to any treaty provision that was in effect prior to August 16, 1954, even with respect to new amendments of the Internal Revenue Code.

Code Section 894(a) states that income of any kind, to the extent required by any treaty obligation, shall not be included in gross income and shall be exempt from tax. That provision does not have a date so it would apply with respect to all treaties, whether or not they are pre-1954 treaties. The language of Section 894(a) is not very broad in scope. It merely deals with what is included in gross income, and not with other types of treaty provisions.

In enacting the Revenue Act of 1962, Congress expressed its intent to override existing treaty obligations, in Section 31 of that Act. A Conference Committee Report indicated that in the view of the Treasury there was only one conflict between the Act and treaties, a minor exception relating to the real estate clause of the Greek estate tax treaty. The conflicting treaty provision was successfully renegotiated shortly after the passage of the Act.

In enacting the Foreign Investors Tax Act of 1966, Congress expressed its intent not to override any existing treaty obligation. Section 110 of the Foreign Investors Tax Act (not codified) provided that *"no amendment by this title shall apply in any case where its application would be contrary to any treaty obligation of the United States"*.

The Senate Committee Report on H.R. 2297, [5] the Synthetic Rutile Bill, contains this clear expression of proposed Congressional intent:
*"The amendments made by the provision will generally apply to dispositions after December 31, 1979. However, for a five-year period, gain will not be taxed to the extent required by treaty obligations of the United States. After that five-year period, for the renegotiation of conflicting treaty provisions, that is, after December 31, 1984, the provision will prevail over any conflicting treaty provisions remaining in effect."*

It seems clear that Congress can override existing treaty provisions and that it apparently intends to do so in this case.

Real estate is only one of the areas where Congress may try to override treaties. Another is the foreign tax credit area, where several issues may be affected by existing treaty provisions. For example, what is a foreign income tax, and what limitations on credit should be imposed?

David Brockway, International Tax Counsel of the Joint Committee on Taxation, will deal with some of the policy questions as to whether Congress should override tax treaties and, if so, whether they should give the Treasury time to renegotiate these treaties.

When the treaty override question was raised in 1962, there was a barrage of protest from lawyers. The Committee on Taxation of Foreign Income of the American Bar Association said that the unilateral modification of tax treaties was, *"a shocking, unconscionable, and unnecessary violation of international agreements"*. Thus far, there has apparently not been any such strong opposition to the current override proposals.

4. Lee Yen Tai v. United States, 185 U.S. 213, 221 (1902).
5. S. Rep. No. 96-504, 96th Cong., 1st Sess. (1979).

# Override of Tax Treaties by Ordinary Legislation

by David Brockway *

Before trying to answer Marshall's questions or address them, let me make a couple of general comments on his remarks.

First, I agree generally with what Marshall has to say about the power to override treaties by legislation. If there is a difference in our viewpoints, it is one of emphasis, and that is in the question of what is necessary for a statute to override an existing treaty obligation. I am not convinced myself that it is necessary for Congress to express clearly in the legislation its intent to override as such in the way it was done in the real estate bill, where we indicated that this was our particular purpose. I think that perhaps what the authorities stand for is the general rule of interpretation that you try to read the statute and the treaty in harmony and try to avoid a conflict if possible; that a subsequent statute should be viewed to be in conflict with and thus to override an existing treaty only if it was clear and distinct from the words of the statute and the treaty that there was an actual conflict between the provisions, but if he conflict is in fact clear and distinct it is irrelevant whether or not Congress ever expressed its intent to override as such. One project we are working on at the moment is a report on the foreign tax credit and the interrelationship of the credit and the tax treaties. We are going to have to take a position at some point this year on the question of what is necessary for legislation to override a preexisting treaty obligation; so by that time my thoughts will have been developed a little more fully.

**Treaty provisions mostly prevail over Code**

In any event, I think that, as Marshall said, the problem is basically solved at the moment by the Code provisions that say that, with respect to exemptions from income, the treaties prevail notwithstanding contrary Code provisions and, in the case of pre-1954 treaties, the treaties prevail in all respects. I should just note, however, that there is at least some possibility that those

* International Tax Counsel of the Joint Committee on Taxation.

 

provisions will be examined by Congress within the next few years to see whether it wants to stick with the exact principles of Sections 894 and 7852. Whether these provisions are going to be changed is another question, but I think there is some concern, at least in the Ways and Means Committee, as to the general relationship between treaties and the statute.

I also note, as an aside, that in the Nat Boidman article that is in the materials, he mentions that in both the United Kingdom and Canada their principle is also that subsequent legislation will override a treaty. That being the case, I do not know that it is so shocking that we also take that position, although I gather from his article that they have the same reluctance that we do actually to invoke that power. After yesterday's discussion, though, I am somewhat reluctant to rely on Canadian and British precedents, after hearing that they do not take legislative history into account when interpreting statutes. That kind of thinking could put me out of work.

Turning to Marshall's principal question of whether we should override the treaties in the real estate bill, I would rather address the issues involved in whether Congress will override treaties in the bill rather than trying to make any judgment as to whether it would be appropriate for them to do so. First, as Marshall indicated, I do not think there is a great worry with respect to real estate held directly by foreign investors. There are only the two treaties, one with Canada and one with the United Kingdom, which limit the right of the United States to tax gains on U.S. real estate. The U.K. treaty will, I hope, go out of existence pretty soon. The Canadians have legislation similar to that we are contemplating and they would like very much to reach an agreement where each country can tax real estate gains by residents of the other country, and so I do not think there is going to be any great problem in reaching an agreement on that point, assuming we can ever get a treaty with Canada. My assumption is that within the five-year period, whether or not we put anything in the statute, there will be a change in both of these treaties on this point.

## Real estate companies

Our larger problem is with corporations formed or availed of to hold real estate. It is something we have to deal with one way or another. The problem is that, if we just taxed the sale of real estate, the obvious alternative for a foreign investor holding stock in a corporation holding U.S. real estate is to sell the stock in the corporation, with the result that the new buyer gets a stepped-up basis and then liquidates the corporation without any U.S. tax. There are a number of possible ways of dealing with this problem. At the moment our judgment is that it is going to end best if we attempt to tax the sale of the stock. We have all along considered the notion of perhaps denying Section 336 treatment on the liquidation rather than taxing the sale of stock. Maybe we rejected it too soon and we are giving additional thought to that option. It would avoid many of these problems. In fact, one of the great attractions of that approach is that it does avoid the treaty problems. But for the moment, let us assume that the legislation will involve taxing sales of stock in U.S. real property holding companies.

Then the question is: will the Congress want to override the treaties if there is not a renegotiation within a reasonable period of time? I think there was a reaction that as long as there is one treaty outstanding which permits third country nationals to take advantage of that treaty, the legislation will not work. Right now, obviously nobody uses Polish holding companies, but there is no doubt in my mind that if the capital gains provision is changed in all those treaties except for the Polish treaty and if Poland would not effectively tax that income, Poland would become the new Netherlands Antilles.

## Renegotiation of tax treaties may be difficult

I think that there is a feeling that something has to be done about the treaties which would prevent the United States from taxing foreign investors on gains on sales of stock in U.S. real estate holding companies. The Treasury is very concerned about the problem. I suspect with their attitude at the moment that there is no need at all for the provision in the legislation overriding any conflicting treaty provisions remaining after a five-year period for renegotiation. Realistically, they are going to try very hard to renegotiate these treaties on this point within the five-year period. However, the difficulty from Congress' standpoint is that it does not have control over whether or not the Treasury will actually succeed in renegotiating these treaties in that time frame. Notwithstanding Treasury's present intention, there is some awareness that if there is not something that automatically works to conform the treaties to the legislation after a resonable period, once the legislation is passed taxpayers will petition both the U.S. Government and the foreign governments about the problems of revising the treaties on this score, and it may prove to be very difficult to have all the treaties renegotiated in the reasonably near future. In fact, attorneys for foreign investors in U.S. real estate have warned me that I should not hope that the foreign governments were going to agree to renegotiate the treaties to allow us to tax this income. And I think there is some reality to that. For example, there has been a great deal of discussion on the issue of whether or not the Netherlands Antilles treaty should or should not be revised. I do not think that any of you would be surprised to hear me to say that it is not purely an academic issue. There has been a certain degree of pressure exerted on that issue and it is my guess that there would be in this context too. Consequently, it may not be so easy to renegotiate all the treaties to conform them to the legislation unless Congress in the legislation says that it is very serious about this and that the Treasury will have to act in one way or another.

## Possible approaches

Having said that, I am not sure that the Congress necessarily has to do what was done in the Senate bill. It may well do what is in the Senate bill or it may well limit the degree to which it overrides the treaty. It does not really like to override tax treaties. I think there are some members who see restrictions on tax treaties as a positive good, especially some members of Ways and Means, but I think that most do not like overriding tax treaties and like to avoid doing so if possible. The principal concern here is one of avoidance of all taxes by the foreign investor, not so much of whether it is the United States or some foreign government which gets the revenue. In the present situation, there are many situations where U.S. real estate is held by third-country investors through a Netherlands Antilles holding company and no capital gains tax is paid to any country on the disposition of that property — that is the problem that is the real concern. So, conceivably, the legislation could limit the treaty override to situations where the stock of the foreign corporation is not directly or indirectly held by individual residents of the treaty country. That would substantially minimize the problem and should, at least in my view, deal with the legitimate concerns of the foreign government. There is no reason why foreign governments should have a strong concern in protecting the tax-free nature of investments by third-country investors.

Another possibility would be to limit the situations where the legislation overrides treaties to those where no foreign tax is paid or perhaps give a credit (a 906 credit) for any foreign tax paid on it, just to say to those governments with which we have made treaty arrangements — which essentially are agreements governing how the two countries are going to share tax revenues — that we are not attempting to take their tax revenues; that all we are attempting to do is to make sure that our legislation works as a practical matter, and we are willing to live, at least until we can reach a renegotiation of the treaty, with their getting the revenue on the gain as long as one of the two countries taxes it. In that regard, you might see possibly a combination of these two approaches.

Another possible approach would be to notify the foreign government of the legislation in some formal manner and ask them if they want to renegotiate the issue and give them the option of either renegotiating in a reasonably short period of time or telling them that we are going to terminate the treaty. You do not violate the treaty provisions that way and it is up to them to determine how seriously they take this issue. That is a possibility we have not really explored.

Another approach, and it may be, again, combined with some of these others, is to set out in the statute a defined and limited scope in which to renegotiate this issue, delegating to the Treasury the authority to enter into some sort of executive agreement to deal with the real estate problem. I do not know how well that would fly on the Hill. I listened with interest to David's remarks yesterday in which he advocated a very broad delegation of power to the executive through the competent authority process. I think I can safely say that the Congressional viewpoint on executive discretion in these matters is somewhat different. You know, we are all sort of prisoners of our institutional roles. But, there might be some way that Congress could specify exactly what it had in mind, establishing an executive agreement procedure to resolve the real estate issue but which could not be used to negotiate foreign tax credit issues and everything else. It might be possible just to deal with the treaty provisions limiting the taxation of real estate directly or indirectly held by foreign investors — to renegotiate that issue alone, and, as long as it fell within the scope of what was set forth in the statute, let it go into effect without going through the regular ratification process. Alternatively, Congress might develop a model that could go through Foreign Relations with some speed, a model which set out the types of concessions it thinks would be appropriate to make to the foreign government in exchange for their agreeing to our desires.

The question of whether Congress wil override in a large part depends upon how the statute is set up. If the statute is set up the way the Finance Committee bill is set up, I think there will be an override to some extent. Now, if it is modified, the need to override may diminish quite a bit. An example of where modification might diminish the need quite a bit is if we gave foreign investors a fresh start on the basis of any U.S. property they presently hold. If that were done, then in the next five years we would not pick up any significant revenue from the legislation in any event and so any need to override becomes less and less important. But under the Finance Committee Bill I would expect there would be at least some limited override.

## The five-year period

On the question — Marshall's second question — of whether five years is an appropriate time, I do not remember where exactly the five years came from. It was in the Wallop bill in 1978 — I guess that is when it was first introduced and I truthfully just do not know where we got five years from other than that we have five years in a lot of other places so why not here. There was in fact some attempt made to analyze whether that period was too long or too short, but once someone had thought of a number, the inertia of having that number meant someone would have to justify another number and so I think you will find the five-year period sticking unless there is some substantial change in the bill as a whole because there is no particular rationale for any number. There is one area where conceivably it might be shorter. There has obviously been a fair amount of — I do not know what the euphemism is but I think I have heard it referred to as "upgrading" — but in any event I have been told that there have been quite a few transactions prior to the effective date in bearer shares of Netherlands Antilles corporations in order to get a fresh start in the basis of those shares. You do not know who is selling to whom but it is a reasonable assumption that they are related parties. One planning technique I have heard discussed is to take existing Netherlands Antilles real estate holding companies and drop their stock down into a Netherlands subsidiary to take advantage of the capital gains provision of the Netherlands treaty. I do not know whether that particular technique actually works under the non-recognition rules in the Bill, but there may be an abuse potential. If the Bill stays in the form it is now — that is, if the tax is imposed with reference to historical basis rather than allowing foreign investors a fresh start as some have urged — I think that possibly in this type of abuse situation there may be some sort of earlier override, although the Treasury would resist that fairly strongly.

## General comments

Finally, if I could make just a couple of general comments. As I said before, I think there is, for most members of Congress, a great reluctance to override treaties unilaterally. They would rather figure out some way to work it out and I think we are going to try to some extent to modify this legislation to take that into account. I think they respond to the same policy issues that the bar committee responded to. I do not think that their attitude is quite the same; but we all recognize it creates problems with our treaty program if we enter into agreements and then unilaterally override them. Having said that, I think the potential for conflict between the treaties and the statute is increasing and at some point we are going to have to work out a way to resolve the conflicts. One reason for the increase is just that international business is increasing a great deal so that the treaties have become much more important. The awareness of the impact of treaties is also increasing a great deal. I think this is attributable in large part to the U.K. treaty because it was such a political issue. It upset a number of people on both sides and made them very wary of tax treaties. And also I think the Netherlands Antilles treaty gets a certain degree of publicity and highlights the issues in this area. The hearings in the Gibbons Subcommittee contributed to this. While I understand the feeling of that bar committee, I do not think Congress is going to ignore its jurisdictional prerogatives and that in large part may govern how they are going to react. The treaties, of course, are negotiated by the Administration without any Congressional input and they are presented to Congress essentially on a take it or leave it basis.

It is extremely difficult to change anything in a treaty after it has been signed. They govern most investment within and without the United States and major changes in tax policy are made through the treaties. For example, our whole withholding tax area is basically governed by the treaty policy rather than the policy of the statute. The insurance excise tax appears to have been effectively repealed through the treaties without any disclosure to Congress that this was happening. People wonder why I bring that up from time to time, but, to put it in context, we used to collect more revenue from the insurance excise tax than we did from the interest withholding tax. The modification of our tax policy through the treaties is a very real issue for the Congress, and in particular for the Ways and Means Committee, which does not participate significantly in the formation of treaty policy. There are Members who are very concerned about their role in the process of setting U.S. tax policy. Even in the Senate, Senator Gravel pushed in the Senate Finance Committee during its consideration of the 1978 Act for legislation that would take the jurisdiction of the tax treaties out of the Foreign Relations Committee and give it to the Finance Committee. That issue was avoided because the Senators do not like to have conflicts along those lines, but it indicates to some degree the concern there. If the tax writing committees write legislation which is regularly overridden by treaties in which they do not have any significant input, and if the tax writing committees have no practical way of changing those treaties, what you will find is that inevitably they will react adversely to the tax treaty process. Whether we have override in the future in any degree turns on whether the negotiators of the treaties take into account the concerns of Congress. One major concern is how broad the scope of the treaties is — whether the negotiators stick to actually eliminating double taxation (that is, actual taxation in a foreign jurisdiction and actual Federal taxation in the United States of the same income). A second concern is the extent to which they attempt to bring in novel provisions. I realize the desire to deal with particular problems that crop up differently in each country, but the more different types of provisions there are, the greater the possibility of a conflict between any legislative change Congress might want to make and some existing treaty obligation. Also, it is much more difficult for Congress to assess the impact of these new and different provisions. A related point in this area is the number of treaties. It is one thing when you have ten or fifteen treaties and they are basically similar and maybe you can renegotiate them without any great difficulty to reflect a tax policy change decided on by Congress. However, our treaty network is expanding very rapidly and there really is no possible way to renegotiate all our tax treaties in a short period. As Marcia Field indicated yesterday, Treasury is negotiating treaties with Malta, Bangladesh, Cyprus — that type of jurisdiction. The more treaties we get, the more and more impossible the process of attempting to renegotiate the treaties becomes. Eventually you may find Congress feeling itself somewhat tied in knots and just saying, "Well, we are going to override the treaties statutorily", unless a general agreement of all the parties is reached as to what are the appropriate matters to be included in treaties. There will have to be general agreement on the part of the tax writing committees that what is included in the treaties is acceptable to them. The treaties will have to be fairly limited in scope and not change that much from country to country in order to minimize the possibility of conflict between the treaty program and the desire of Congress to establish and control U.S. tax policy, particularly as it affects U.S. nationals and U.S. businesses anywhere in the world but also U.S. tax policy with respect to income of foreign residents and businesses that directly or indirectly arises out of the United States. There is a necessity that there be some agreement as to what the treaties should do, or there will be continuing conflict and more instances where Congress determines that it is necessary to override existing tax treaties unilaterally in order to implement changes in U.S. tax policy which it decides to adopt.

# Mutual Agreement Procedure

by John F. Avery Jones [1]

I am going to speak about *mutual agreement procedure* and having heard Mr. Rosenbloom yesterday, I imagine it has another name in this country. Perhaps something like "the unilateral expression of views informally cleared with the other side" procedure.

I come from a country where the competent authority, the Inland Revenue, sometimes think they can write the tax laws. This came to a head the other day in a case in the House of Lords, the final court of appeal, in a case called "Vestey". I will not bore you with the details but what the tax authorities were claiming was they could decide not only whom to tax, but how much to tax them, under a particular piece of anti-avoidance legislation. I will read you just a short extract from one of the judges in the House of Lords, Lord Wilberforce, the senior judge, where he said this: *"A proposition that whether a subject is to be taxed or not or that if he is, the amount of his liability is to be decided even though within the limit by an administrative body represents a radical departure from constitutional principle. It may be that the Revenue could persuade Parliament to enact such a provision in such terms that the courts would have to give effect to it. But, unless it has done so, the courts acting on constitutional principles not only should not but cannot validate it."* I would like to put that concept into a United States context and ask you to imagine that the U.S. Model Convention, instead of reading as it did, contained just one article which reads as follows: *"The competent authorities may grant such relief from double taxation as they shall think fit."* Now if the Senate — and from my limited viewpoint from the other side of the Atlantic it seems to me that the Senate takes just a slight interest in what goes into tax treaties — were to pass such a provision, then I have no doubt that everything Mr. Rosenbloom said yesterday would be true. And I think I would even carry Mr. Brockway with me.

But the question which faces us this morning is not that at all. I want to pose the same questions in relation to the OECD Model. I suppose I should pose the questions in relation to the U.S. Model but my excuse for not doing so is that I am less familiar with it and in any case, it has not been adopted very widely so far. So, let me turn to the OECD Model and incidentally to the paper which you have with your bundle of papers.

## Three types of mutual agreement in the OECD Model Convention

Now, like Gaul, I shall dvide the subject into three parts because in the OECD Model there are three types of mutual agreement. For those of you who do not have the model near you, I will jsut remind you what they are. There is Article 25(1) which talks about "transfer pricing", particularly where the individual taxpayer can ask (he can only ask) his competent authority to take up his case with the other country with a view to the avoidance of taxation not in accordance with the convention. That is the first type of agreement. The second type of agreement is found in the first sentence of Article 25(3), which provides that *"the competent authorities of the contracting states shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the convention"*, to which I shall refer as the interpretive provision. And the third type goes on to say, *"They [that is the competent authorities] may also consult together for the elimination of double taxation in cases*

1. *Editor's note.* See also J.F. Avery Jones et al.: "The legal nature of the mutual agreement procedure under the OECD Model Convention" in British Tax Review 1979 at 333 and 1980 at 13.

*not provided for in the convention.*" A rather surprising provision, you may think.

I do not claim that all types of mutual agreement neatly fall into one of those three categories. Obviously, there is an overlap. The specific case may be because there are doubts about interpretation of the convention. But, let us just use that as a framework.

### A valid delegation?

Let me start at the end with what I described as a surprising provision, that is, that the competent authorities can eliminate double taxation in cases not provided for by the convention. In the United States, although this provision is in the model, my understanding is that it has only been used in treaties with Hungary and Poland. The provision is also not used in the United Kingdom, although my tax authorities were rather surprised when I pointed out to them that they had, in fact, used the provision once. Now we come to the point of validity. Let us assume that the competent authority does just that. And we turn up in court and we want to know what is the effect of that agreement. To put it another way, is there a valid delegation by, as I understand it in the United States, the President, with the advice and consent of the Senate, to the competent authority to add to the treaty. Now that, I think, is a very interesting question, and the fact that the provision is formed in two treaties means that it is no longer academic. It does seem to me that when it did get into those two treaties a point of very fundamental constitutional law was involved. And therefore, I looked, as I understand you spend all your time looking, at the legislative history, to see what was said about these provisions: "*The proposed treaty [this is the treaty with Hungary] contains various administrative provisions generally along the lines of the provisions contained in other U.S. treaties*"; and in relation to the treaty with Poland: *Thus, the proposed convention with Poland in general follows the approach of other U.S. income tax treaties.*" Well, I suppose these things cut both ways. If one must read the legislative history to find out what the treaty means and the legislative history does not draw attention to what the treaty appears to say, it may be that the treaty does not mean what it appears to say.

There, I think, is our first and very substantial point. I can tell you very roughly what the view in other countries is about this provision. It is difficult because a lot of other countries do not in fact adopt it. But Switzerland and Sweden appear to give it some validity. I have not, to my knowledge, found another country, with the possible exception of the United States, which is prepared to say that such a provision would in fact have legal validity. The reason I have a question mark about the United States is that if you read the legislative history, including the commentary to the OECD model, I think you will probably come to the conclusion that it was intended to be a delegation. Thus the answer is that it is probably legal but just wait until the Senate finds out about this. I do not know if Stanley Surrey is still here, but I gather he had a spot of bother trying to get a very much narrower provision through in the French treaty at an earlier time.

Well, so much for the surprising provision which, as I say, is not used very much. Let us look next at the more important one, the one about interpretation. "*The competent authorities shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the convention.*" And the question here is exactly the same. Is that a valid delegation by the President with the advice and consent of the Senate to the competent authority to agree? And I do emphasize agree. I do not think that a unilateral statement of opinion can possibly have any force. I am not an American lawyer but, I do think, even in this country it takes two to make an agreement.

Supposing we do have an agreement with the other competent authority as to the interpretation of a convention, what is the agreement's legal validity? Would you mind turning to page 348 in the paper which you received and you will see at the top of the page four propositions: [2]

(a) Whether there is any constitutional or other reason preventing delegation of the power to make such an interpretive agreement that is binding on the courts. And, as far as I know, the answer in this country is that there is no constitutional reason preventing it.

(b) If there is not, whether it was the intention of the interpretive provision that an interpretive mutual agreement should be binding on the courts. That, I feel, is a matter where the Senate comes in.

(c) If so, whether the mutual agreement is a valid exercise of such a power, i.e. whether it falls within the power granted by the interpretive provision, e.g. whether it is interpretive rather than legislative. That, of course, is in a treaty which does not contain what I described as the surprising provision.

(d) If so, was the agreement intended by the competent authorities to exercise its powers under the interpretive provision.

That is where the competent authority comes in but, I think, that it is the first time the competent authority comes in. I think the law is that they come last, and what matters in the legal hierarchy is what the Senate thinks. Here again, some countries will accept that there is a valid delegation. This is a matter of internal law and I can quote Sweden and Switzerland again as countries where that is the case. I can equally quote, and you will see this at the bottom of the same page, Germany, Belgium, Canada, Japan and the Netherlands, where it is quite clearly not accepted as a sufficient delegation and they make the comment that the position is quite different. Interpretation of a treaty is in the last resort the prerogative of the courts, which I also hope, is the position in this country. You will see we do not say in this article what the position in the United States is, and I cannot speak for Sidney Roberts, but presumably the reason we do not say that, and the same is true of the United Kingdom, is because the position has never been tested in the courts. This makes me think that maybe some of Mr. Rosenbloom's remarks were wider than is justified by the present state of judicial decisions.

### Is mutual agreement binding on the courts?

When I say: the courts may not give effect to the agreement as a legally binding agreement, I certainly do not go as far as saying that the court should take no notice of the agreement. If I can again speak in American terminology, the agreement is something like what the courts would do to a revenue ruling. At least they will read it. They will give some weight to it. I do not know, or perhaps I should say I gather Sidney does not know, exactly what weight is given by the courts in this country to an interpretation agreement.

You will see, on page 350, [3] the extract from the Vienna Convention that was mentioned yesterday, "*there shall be taken into account together with the context, any subsequent agreement between the parties regarding the interpretation of the treaty*". Now that seems to me to fit this admirably. Here is a subsequent agreement, as to interpretation of the treaty, and what the codification of international law made by the Vienna Convention seems to be saying, is that you should take it into account, which is very different from saying that it is legally binding.

2. See article indicated in note 1, British Tax Review at 348.
3. Id. at 350.

### Does mutual agreement bind competent authority?

So much for the courts. What about the competent authority? The OECD commentaries say that the mutual agreement in this context is binding on the competent authorities. I find it difficult to know exactly what this means. The way I would look at it is, supposing the competent authorities were arguing a case in the court. Could they go against such an agreement? Here again, I can quote two countries where they cannot. Obviously again, Sweden and Switzerland because it is binding on the courts anyway. We could include Germany, Belgium and the Netherlands as countries where the competent authorities could not argue to the contrary. As I understand it, in the United States and Canada there is absolutely nothing to stop the competent authority from arguing any proposition it likes in the courts. Certainly in Canada it is done so and, in the United States, it has argued against a ruling or something like that.

Just to summarize at this particular point, it seems to me that (I suppose I should not say what the position seems to me to be, but I should pose questions for you to answer) if the competent authority makes an agreement with the other competent authority on the interpretation of a treaty; first, does the agreement bind the courts absolutely? And the andswer to that seems to me fairly clearly to be "no", although it has never arisen. Second, are the competent authorities even in the position to argue to the contrary in the courts? I would hazard a guess that they probably are. So I trust that that analysis — and I think that is the correct analysis whether or not I have come to the correct conclusions — is the sort of analysis which one should put to Mr. Rosenbloom's remarks yesterday in determining what is the legal status, and what matters is the legal status, of an agreement made by the competent authorities.

### Relationship between mutual agreement and court decision

Let me now look at the most familiar type of mutual agreement, the one that, if I had asked anyone before I started what mutual agreement was all about, I am sure you would have all said: it is the familiar one about transfer pricing and all that. Just let me make a few, I am afraid they will be disconnected, comments on what I think the scope of this is. In asking a similar question, what is the relationship with the courts, the question is, I think, differently posed because one is not interested in what is the validity in the courts of an agreement made between the competent authorities relating to a single taxpayer dealing with a case of, say, transfer pricing. If the taxpayer does not like the agreement he can just not accept it. I think the question here is, can you make the agreement at all? Any taxpayer, of course, has a choice. He can either go to court or he can go to the competent authority and, indeed, subject, of course, to time limits, he can do both in either order. Except, I understand, in Sweden where you have to make the choice at the very beginning. It is always worth bearing in mind if you are in this field that what matters is not your law, but the other person's law. Supposing one tries the mutual agreement procedure first and it fails. They do not reach an agreement or the agreement is not satisfactory to you, what can you do? You can go to court. And, as far as I know, with the exception of Sweden, certainly of the countries considered in this article, there is nothing to stop you going to court as long as you have kept your time limits open and that's a fairly straightforward matter.

Now, what about the other way around? You go to court in either or maybe both countries and you do not like what the court decides. Can you now have a mutual agreement? Well, first of all, there is the time limit aspect. You have got to present the case within three years from the first notification of the action resulting in taxation not in accordance with the convention. I do not know how fast the courts are in your country but three years would not be an awful long time in my country. Assuming we are still within the time limits, can you override (and this is implicitly in favor of the taxpayer, of course) the court decision? As I understand it, you cannot in the United States unless the treaty says you can. If the treaty overrides all procedural barriers then the treaty means what it says. If the treaty says you can merely override internal time limits then, as I understand it, the position is, and it is the same in France, that you are stuck. You cannot vary the mutual agreement because the court decision is final. In other countries that is not, in fact, the case. Canada, for example, has legislation which specifically states that the mutual agreement can override a court decision. This makes me think, because as you heard David Ward say yesterday they have taken our legal system, that probably in countries like mine and Australia you are in the position that, there being no legislation to say that you can override it, you cannot do so. But that is uncertain. It has never happened in my country. But certainly in other countries, and I can point to Sweden, Switzerland, Japan, Netherlands, Belgium and Germany, it would be all right to override it. I think all that points to a proposition I made a moment ago, that really what counts is not your law but the other person's law, and if you start a mutual agreement procedure, or you start court proceedings, you have got to know where you stand in the other country.

### How does mutual agreement fit in the legal system?

I do not want to take up any more time in introducing the topic but to come back to the main point which I would like to make: how does the mutual agreement procedure fit in with the internal legal system? In most cases, the answer seems to me that it just does not fit. You have this proposition that maybe you cannot have a mutual agreement after the court proceedings in some countries. It may be that if you do have a mutual agreement you are out of time for applying it, either in your own or in another country. That, of course, is subject to the point in the OECD Model which now says that you can implement it notwithstanding time limits. (There is a rather fascinating point on this. You have a statement in the new U.S. — U.K. treaty which says that any mutual agreement made shall be implemented and I gather there is a revenue ruling which says that means you override the time limits. But, the United Kingdom put in a reservation about overriding time limits so I think you may have pulled a "fast one" on us, as I do not think we realized what you said, or what you meant when you did say it.) And then, lastly, there is the point I started with. What is the legal effect of mutual agreements, either on the question of interpretation or on my surprising provision over rewriting the treaty? It seems to me very odd that that is a subject which, at this late stage in legal history, we could still be arguing about and I think it is certainly very unclear. So if I can say rather what the law should be, rather than what I think the law is, I think there certainly should be provisions which bring the mutual agreement procedure into the internal legal system. I can quote you Japan as one example, which specifically extends time limits under their internal law when a mutual agreement has been made.

May I end by hoping that I have asked some of the questions. I certainly do not claim to have answered them and I hope that this is a subject which we can consider in greater depth at the conference in Berlin. But, I do believe that this is the constitutional question of the 1980s. It is the question of what is the power of the competent authority? And what is the power of the Senate?

# Source Rules in U.S. Tax Treaties

by Paul McDaniel *

I should explain that my initial assignment in this part of the program was to comment on the very fine paper and outline prepared by Bob Patrick. But as we talked about the reflections that his paper inspired, it seemed it might be more useful to reverse the speaking order. Thus, my comments on Bob's observations will come first and then his formal presentation will follow. I hope the reason for that change in order becomes clear.

The purpose of my remarks is to raise some issues with respect to the treatment of source rules in U.S. tax treaties. I approach the matter by asking this question: *"In what situations is it appropriate or necessary for the United States to consider modifying its statutory source rules by treaty?"* (In my remarks, I assume that the present statutory source rules are acceptable; I am not proposing to question the wisdom or desirability of those particular rules.)

Bob Patrick's discussion then will provide an analysis of the actual instances in which such source rule modifications have been agreed to by the United States or in which modifications would be made by the various model treaties. Moreover, I think as you consider Bob's analysis, a further question will be raised: Whether we can discern from existing U.S. treaties principles which do in fact appear to guide the United States when it agrees to modify its source rules by treaty.

It is important to keep in mind the elementary proposition that the U.S. statutory source rules are not self-operative taxing provisions themselves. Once an item of income or deduction is sourced, it remains for other provisions to provide the tax results that flow from that sourcing.

In my remarks I will examine three categories of operative tax rules to try to identify the situations where treaty modification of U.S. statutory source rules is appropriate for consideration.

> I. *Category One:* The issue is potential double taxation of U.S. persons doing business or investing in another country (hereafter referred to as "Country A") because the source rules of the United States and Country A conflict, with the result that the foreign tax is not fully creditable for U.S. purposes.

There are various combinations of source rules which potentially produce conflict.

A. As to items of gross income:

*Case 1:* The United States sources the income in the United States; Country A sources the income in Country A. Double tax may result and in this situation the U.S. may consider modification of its source rules by treaty to prevent that result.

*Case 2:* The U.S. sources the income in the United States; Country A also sources the income in the United States. There are no problems of double taxation here because of the agreement on the source rules. But, as I will discuss later, despite this agreement on source rules, it is possible for problems still to arise, as the 1978 French protocol reveals.

*Case 3:* The United States sources the income in Country A; Country A sources the income in Country A. Here there is no problem because the U.S. foreign tax credit will operate to relieve double taxation.

*Case 4:* The U.S. sources the income in Country A; Country A sources the income in the United States. As long as Country A is an exemption country there is no double tax problem. There is a certain circular problem which arises if both countries are foreign tax credit countries, but it is not a problem of double taxation.

B. As to deduction items:

*Case 5:* The U.S. treats the deduction as U.S. source; Country A as A source. The U.S. foreign tax credit is increased and there is no problem of double taxation.

*Case 6:* The U.S. treats the deduction as U.S. source; Country A as U.S. source. Again there is no problem of double taxation.

*Case 7:* The U.S. treats the deduction as A source; Country A as A source. The U.S. foreign tax credit is reduced, but no double tax problem results because the Country A tax is also reduced.

*Case 8:* The U.S. treat the deduction as A source; Country A treats the deduction as U.S. source. Here the U.S. foreign tax credit is reduced, but A's tax is not. This is the appropriate case for the U.S. to consider treaty modification of its source.

Thus, in Category One, out of eight possible combinations of source rules, only two give rise to potential double tax problems: When both countries source an income item as domestic; and when both consider source of deduction items as foreign (Cases 1 and 8). In these situations, the U.S. may consider modifying its source rules by treaty. The question we can ask then, as we look to the discussion by Bob Patrick, is the extent to which the treaty source rules that have been agreed to by the United States modify our statutory source rules to meet one of those two situations.

> II. *Category Two:* The issue is the United States taxation of foreign persons doing business or investing in the United States. Again one can look at the matter by examining the same eight cases as in Category I.

A. As to items of gross income:

*Case 1:* The U.S. sources the item in the United States; Country A sources it in A. Because of the possible double tax result, the U.S. could consider modifying its source rule.

*Case 2:* The U.S. sources the item in the U.S.; A sources it in the U.S. No double tax problems are created by the source rules.

*Case 3:* The U.S. sources the item in A; Country A also sources it in A. Again there is no double tax problem, unless the U.S. treats the income item as effectively connected income under Section 864(c)(4). Although in the latter situation the U.S. gives a Section 906 foreign tax credit, the U.S. could deal with the issue by providing in the treaty that only U.S. source income attributable to a permanent establishment is subject to U.S. tax. This approach was adopted, for example, in the U.S.—Swiss treaty.

*Case 4:* The U.S. sources the item in A; Country A sources it in the U.S. There is no double tax problem; if the Section 864(c) rules come into play, the situation is like Case 2.

B. As to deduction items:

*Case 5:* The U.S. sources the item in the U.S.; Country A sources it in A. The U.S. tax is reduced so there is no problem of double taxation.

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* Professor of Law, Boston College Law School.

*Case 6:* The U.S. sources the item in the U.S.; Country A sources it in the U.S. The U.S. tax is reduced and there is no problem of double taxation.

*Case 7:* The U.S. sources the item in A; Country A sources it in A. Again no problem of double taxation arises from the source rules. If Section 864(c) applies, the situation is like Case 5.

*Case 8:* The U.S. sources the item in A; Country A sources it in the U.S. Here there is a double tax, and it is appropriate to consider a change in the source rule by treaty.

Thus, in Category Two, the same two combinations of source rules present cases where the U.S. might modify its source rules: Where both countries source an income item as domestic, and where both countries source a deduction item as foreign. (One possible additional candidate is where Section 864(c)(4) treats an item of gross income as effectively connected with a U.S. trade or business.)

III. *Category Three:* The issue is the qualification of a U.S. individual or corporation for a U.S.–granted preference (tax expenditure).

Examples include Section 913, which is based on foreign source earned income, and deferral, which operates only for foreign source income of foreign corporations. In these situations, the source rules operate as eligibility standards to determine (in part) whether the taxpayer can qualify for the tax subsidy. As a treaty matter, modification of the U.S. source rules in these cases is a question of extending or cutting back the statutory tax preferences.

### The 1978 French Protocol issue

Even though there was no disagreement that dividend and interest income of U.S. citizens residing in France was U.S. source, double tax problems nonetheless arose. The problems were created because of the interaction of residence and citizenship-based tax jurisdiction. The resolution, however, was effected by modifying the U.S. source rule to treat part of the U.S. source income as foreign source and then letting the foreign tax credit rules operate to relieve double tax. We can ask the question whether modification of the U.S. source rules to resolve a non-source rule problem was an appropriate or desirable treaty technique.

# Income Tax Treaty Source Rules - A U.S. Perspective

by Robert J. Patrick, Jr. *

In discussing source rules today as a preliminary introduction to the September Paris Congress on this topic, for which I am serving as the General Reporter, I have been impressed with the schematic framework just presented by Paul McDaniel. At this point I feel very much as if he is sitting back and being able to observe the forest, and I am still laboring out there among the trees. With national reports now having been received from some 24 countries, outlining (in most cases, in some detail). their individual source rules, and also trying to take into account the consequences of source rules for treaty purposes, I am certainly in midstream in drawing conclusions and observations. Therefore, I thought the most useful thing for presentation today would be to concentrate upon one of my concerns in the general report and briefly discuss the application of treaty source rules. This services as an introduction to the larger subject of the general need for source rules and the actual role that they play.

One of my principal objectives in preparing the directive for this topic for the Paris Congress is to provide, through the individual country reports to be printed in the *Cahiers*, some general reference material on individual country rules on what we would call "source of income", or determining the origin of income and expenses. This is a subject on which it is difficult to find analyses or detailed descriptions of individual country rules, as compared to other areas of comparative tax law.

### Source: one of the bases for taxation and tool in relief for double taxation

As a preliminary observation, after having been accustomed to embarrassment over the arbitrariness of certain U.S. source rules, such as our passage of title rule, which has certainly been questioned on intellectual grounds for a good many years, I find upon reading some comparative rules from around the world that I am a little less embarrassed by our own. Moreover, I am not certain at the moment as to how well anyone has been able to deal with some of these issues where it is necessary to determine source of income. I am also impressed that even among countries with substantially common jurisprudence in internal law, there is a wide variation in the rules adopted for determining the origin of income. Moreover, there are a number of items of income for which all countries have some uncertainty about what the proper source should be. I would cite such important areas as currency transactions or income or loss on the disposition of certain assets, while questions of source regarding insurance transactions are among other latecomers to the codification of source rules.

I do want to comment on how one perceives the role of source rules in the first place. My observations are tentative at this point, but I hope the *Cahiers* will provide a start toward future consideration in IFA and elsewhere of the general principles of the subject. From the practical standpoint, I am inclined to regard the concept of source as being a tool that is used to achieve certain results. Most often the practical question is which country is going to tax certain income. Source is what we consider one basis of taxation — source or origin. The other basis, which is widely accepted internationally, is, of course, residence. The United States is almost alone in also using citizenship as a basis for taxation in the case of individuals. Therefore, in looking at the concept of source of income and in determining whether we should change source rules, it is helpful to focus on the fact that generally we are looking at which country is going to have a taxation right. Or, more fundamentally, as I think Paul McDaniel suggested, will there be any taxation at all. After that determination is made, source rules are used again, and probably secondarily, as a tool in relief of double taxation.

These primary operative functions of source rules are the practical limitations on negotiators in tax treaties and are implicit in the decisions of writers of tax legislation. However, it is certainly possible, and in U.S. practice it is a fact, that source rules can be written that are, at least in form, independent of any substantive rules imposing tax. The most challenging question is whether there is any objective criteria or set of principles for judging whether a particular source rule is desirable or, indeed, what the

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source rule for a certain type of income should be. The national reports that were submitted generally do not offer reasons for the rules of national legislation.

What is the answer to this fundamental question? Why do we say income has one source rather than another? One must go to the League of Nations documents, and the Committee of Experts of the League, to attempt to determine the economic connection of income and to find theoretical discussion of this question. No very much theoretical work on this has been done since that time. Different countries have perceived of origin of income in a certain way, and perhaps the knowledge is lost in history, custom or practice of exactly what any legislature had in mind when it decided that the origin of particular income was Country A rather than Country B.

## Significance of source rules

Short of providing the rationale behind particular source rules, one effort I have been making is to identify the relative significance of source rules in national legislation. I believe that with the United States emphasis on these rules, we accord to the concept of source a substantial independent existence as a fundamental feature of our taxation system. But it is very clear, as one reads the other national reports on source rules, that other countries are to a great extent able to function with a tax system that rarely talks about source or origin of income. Nevertheless, every tax system, even when it does not employ the language of source, makes distinctions as to the economic origin of income. They need to know for various purposes the origin of income although they may think only in terms of items that are taxable or non-taxable income.

## Expense allocation rules

For income tax purposes we are generally talking about net income. Regardless of the degree to which a country has developed source rules for income, no other country has sought to deal in detail with expense allocation in the degree that we have done in recent years. Again, at least in theory, other countries have exactly the same problems which the source and expense allocation rules attempt to solve, and that is true whether the foreign system is a territorial system (exempting foreign source income of residents) or a foreign tax credit system. A clear fact emerging from the reports, however, is that the expense allocation rules have been given much less attention and appear to have considerably less development in internal law of other countries than that which has occurred in the last decade in the United States.

A very important part of the subject which I will not be covering in the IFA report should be noted in passing. That omission is the issue of characterization of the nature of income and its impact on source determinations. There are rather fascinating tax consequences that flow from different legal characterizations of transactions that are quite similar in substance and might involve, for example, in one case, the sale of something identified as property, and, in another case, the licensing of a process to make that property, or, in a third case, a contract requiring payment for the services to make that property. The consequences in international tax rules change dramatically from these characterizations, yet we quite arbitrarily divide economic activities into categories and give them very different treatment as to whether they are producing foreign or domestic source income.

## Income tax treaties

I would like to turn specifically to income tax treaties. Both the OECD Model income tax treaty and the U.S. Model treaty (largely based on the OECD) employ rules of source. The development of source rules in U.S. treaties is roughly divisible into pre-1968 and post-1968 treaties. In pre-1968 treaties, the concept of source as such was not given much attention. For example, there was some notion that income originated in Canada, or originated in the United States, or should be apportioned, or perhaps originated somewhere else. But there is little development of this notion in the language of the treaties, and there was no separate article on source rules in these older treaties. Around 1968 (and in treaties as recent as the Korean treaty that finally went into force a year or so ago, but was based on the type of negotiating form that was used in the early 1970s), there is a separate article containing a list of source rules. As one looks at that article, one can see both the issue of how much internal law on source the U.S. was able to urge upon foreign tax systems, and, assuming U.S. rules were adopted, how much could be inserted without a great deal of detailed explanation. One also senses the inevitable incompleteness that arises in trying to incorporate the Internal Revenue Code rules on source. For example, these treaties with separate source rules generally provide that income from the purchase and sale of tangible personal property should be treated as income from sources within the contracting state only if the property is sold in that contracting state. But what about treatment of income from the manufacture and sale of property manufactured in one state and sold in the other? The treaty appears silent on that. I think the U.S. began to perceive drafting problems and questions about the effectiveness of trying to write all U.S. statutory source rules into treaties.

## U.S. Model Treaty

At the time the U.S. Treasury published a Model treaty in 1975, the Treasury made an effort to adopt the OECD language in U.S. treaties. One judgment was that what would be regarded as source rules or their equivalent in the OECD Model were not all that bad for tax treaty purposes; namely, assigning primary taxation in one country and providing double taxation relief in the other country. So the U.S. has made an increased effort to adopt the rules of the OECD Model. Yet, as I will mention in considering some of these specific treaty rules, there are fairly substantial questions as to how clearly they identify origin or source.

The current U.S. Model generally combines source rules in the operative articles themselves. For example, the interest article will contain a concept of origin of the income covered. The U.S. Model treaty also contains, in the tax credit article, some special rules relating to source of income.

## The permanent establishment rule

Looking at the structure of tax treaties, one observation is that there is a very important functional rule in treaties that, where applicable, does supersede numerous detailed rules about the source of different items of income. In using the permanent establishment concept, with income attributable to an establishment located in a country being made taxable in that country, the treaty tells you what you need to know. It permits you to have a general rule and treat as income attributable to a permanent establishment the connected operating and investment income of the enterprise. The fixed base rule has a similar result in the case of independent personal services. Here then is a rule that operates as a source rule in giving a situs to the income and operates functionally with the other provisions of the treaty on relief from double taxation to identify which country is going to tax and which country is going to give double tax relief. It is important, particularly if one is used to looking at tax rules from the United States' perspective, to have in mind the fact that the OECD Model is influenced very strongly by a territorial concept so that if the situs country has the exclusive right to tax the income of the permanent establishment, then under the internal law of a number of countries there is no problem in saying, *"And we the place of incorporation and the company headquarters will not tax that income."* It makes resolution of double taxation easier for such countries than in the case of the U.S. which says, *"However, we are still going to tax United States companies just as if the treaty and its permanent establishment rule had not* *come into effect.*" The U.S., therefore, must provide in the treaty that the fact that the income is attributable to the foreign permanent establishment gives it a foreign source at the establishment for U.S. tax purposes. At that point the tax credit article can provide relief.

However, while the basic rule of the treaties about "attributable income" servies a very useful functional approach, it is my impression there is little guidance as to *when* income is attributable to a permanent establishment or, in the case of individuals, to a fixed base. At least the United States and some other countries have attempted to articulate how you get income effectively connected to a permanent establishment, but there appears to be no generally accepted statement of the principles. The attribution rule, once there is a determination of attribution, is really a rule that, although income in question may arise (under technical source rules) either in the country where the permanent establishment is located or elsewhere, it will be regarded as having its origin at the permanent establishment or fixed base. The U.S. Treasury, when discussing this issue in its technical explanations of treaties, has said that insofar as a foreign company has a permanent establishment in the United States, the income that is attributable to that establishment is narrower than U.S. internal law which provides that all business income is attracted to the permanent establishment. In addition, according to the Treasury, the income actually attributable is not only that generated by the permanent establishment from the activity of the establishment from sources within the United States but it also includes those attributable items of foreign source income of a permanent establishment that the U.S. taxes under the Code; that is, the foreign source income that is connected with certain designated business operations (see I.R.C. Section 864(c)) carried out in contact with the U.S. establishment even though technically, under U.S. law, the income is from foreign sources and, in general, the U.S. does tax foreign source income of non-resident aliens and foreign corporations. This is an illustration of how useful the attributable concept can be as an overriding or substitute source rule.

## Per-country foreign tax credit limitation

I would add as a footnote that it is my judgment that the United States never really has had a true per-country foreign tax credit limitation. I also have some doubts about whether other countries have a true per-country limitation where income flows through foreign affiliates or subsidiaries to the parent country and is commingled, along with foreign taxes, at some offshore holding company or operating company situs. Because of the fact of commingling of income and operations at subsidiary levels, it is very difficult to think of how one would have a per-country rule that would actually work as a practical matter if our full source rules were applied. The simplest illustration of the problem is to take U.S. source rules under a per-country limitation of the foreign tax credit and apply them to, say, a subsidiary in Canada of a U.S. corporation where the subsidiary is making sales both in and out of Canada. As a practical matter, to what extent would anyone in computing the foreign tax credit look at whether or not title was effectively passed outside of Canada in determining whether the sales income of the Canadian company was Canadian source? It is not simple to impose our detailed source rules at either a foreign branch or subsidiary level, and tracing income at a sub-subsidiary level is extremely difficult. For that reason, if anyone wanted to try to write a true per-country rule, one ought to consider looking at the permanent establishment and attributable income concept not only for branches but perhaps for subsidiaries as well. This assumes, however, that there could be agreement on what is "attributable income".

## The "other income" article

A second overriding treaty rule that seems to solve some of the mechanical problems of source is the "other income" article. The significance of this article is often overlooked, but it can assume great importance depending upon how narrowly or broadly defined are other operative articles, such as those covering interest and royalties. The usual OECD or U.S. model treaty provision says that income not specifically covered in another article is taxable only in the place of residence. Income that is subject to this "other income" article may include third country income or it may include income arising from the residence country itself.

## Individual items of income

Turning to the individual items of income under treaties, as I previously noted the U.S. and OECD model treaties place source rules in most instances in the operative taxing rules for various items of income. The exact scope of these rules varies from item to item.

The treatment of income from real property provides perhaps the greatest degree of uniformity in source rules that one finds in any of the national reports. There would be no conflict with the basic rule of Article 6 of the model treaties that real property income has its origin at the situs of the property. In contrast, under national laws there would be a wide variation in the source of income on the sale of tangible personal property. The permanent establishment attributable income rule helps to resolve such conflicts, provided that the double taxation article is coordinated with the taxation article.

With activities such as shipping and air transport where you have international traffic that is a treaty defined concept, you have an international effort to agree on a method of taxing truly peripatetic activities using a special set of rules which frequently modify national legislation.

There is a considerable degree of national uniformity in treating interest as arising in the state of residence of the person paying the interest, but it is by no means the uniform rule under national law even among OECD member countries. The residence rule is adopted in Article 11 of the OECD and U.S. models.

Article 12 of the OECD and U.S. models, covering royalties, provides less assurance as to what exactly is covered. The OECD treaty refers to royalties "arising" in a state. But even in the U.S. model which tries to define where a royalty arises in terms of its use (based on the U.S. statutory rule), it is still not clear how the rule is applied where use in more than one country is involved. Moreover, for drafting purposes, the scope of the source may be defined to affect the result depending upon whether there is going to be exemption from tax or a positive withholding tax in what will be designated the source country.

Special mention should be made of how the treaties are used to define source of income in the area of services, especially with respect to independent services and services rendered by a company furnishing services of employees to others. This is a useful illustration of how treaty source rules are being adapted to resolve current conflicts as to which jurisdiction may have the primary taxing right because of source and which country will give tax relief. There are a number of issues in connection with the source of income from services in the present agreements. These include whether services are covered under the independent services article or under the permanent establishment and business profits articles. The U.S. Treasury, in technical explanations of recent treaties, has attempted to set forth the U.S. position on this question. But the basic negotiating conflict that exists is between taxing income from services based on the place of performance of the services, the rule in a number of countries, versus treating the origin of service income as being the residence of the person paying for the services, or where the services are "utilized", regardless of where the services are physically performed. Of course, for a U.S. taxpayer, use of a rule other than the place of performance as the source rule for income from services immediately raises a foreign tax credit limitation problem, since for foreign tax credit purposes there is no foreign source income when services are performed in the United States.

In this service area, we see increasing evidence of a shift in U.S. treaties toward a treaty change of source. While the U.S. Internal Revenue Code rule says the source is where the services are performed, an increasing number of treaty provisions provide that for purposes of calculating the foreign tax credit, when a foreign country imposes tax on certain types of service income, regardless of where the services were performed, the U.S. will treat the income as from sources in that country. There are provisions of a limited nature like that in the pending Moroccan treaty, where services rendered anywhere on behalf of the Moroccan government are treated as Moroccan source income. There are also provisions in the pending Philippine treaty suggesting some shift in the source of certain service income through rules permitting taxation of an enterprise on a net income basis where services are furnished for 183 days or more. In the pending Jamaican treaty, income from services rendered by a U.S. company to its affiliate in Jamaica and independent consulting services are Jamaican source once an initial threshhold of physical presence has been met. The issue in these latter treaties is identifying the service income "attributable" to a permanent establishment.

## Relief from double taxation

The operative provision of U.S. treaties to relieve taxpayers from double taxation is Article 23 of the U.S. model which provides a credit for covered foreign taxes. The U.S. model and recent treaties do provide some source rules in that article, including rules for interest, royalties and dividends to provide such income with the necessary foreign source content for purposes of the foreign tax credit limitation. In this regard, the U.S. model adopts the OECD approach where income attributable to the permanent establishment that is taxable in a foreign country is going to be treated as if it had its origin there for U.S. tax credit purposes. Thus, income that is taxable in the other jurisdiction will be treated as having a source in that country.

There is then the question of the relationship of the U.S. model treaty's credit article and its source rules to the U.S. Tax Code. Is there an independent treaty credit? Clearly there is. This is expressly provided in the U.S. model. I believe it is also implicit in the history of earlier U.S. tax treaties that, unless there is a statement to the contrary in connection with the treaty, the treaty structure is such that the U.S. assures a treaty foreign tax credit to U.S. citizens and residents for the foreign taxes that are the subject matter under the treaty. The saving clause, under which the U.S. can generally tax Americans just as if there were no convention, says by way of exception that U.S. citizens and residents shall be entitled to the foreign tax credit provided in the treaty. The formulation of the credit article in the U.S. model is that the credit is to be provided under the treaty for the appropriate amount of the foreign taxes covered in the treaty, subject to the procedural requirements of the Code, e.g. gross-up for dividends.

## Protocol to the French Treaty

In its Technical Explanation of the Protocol to the French Treaty that was adopted in 1979, the Treasury stated its position that there is an independent treaty credit and also discussed the per-country limitation. The Treasury says that while the treaty provides a treaty credit for the covered French taxes paid in France on French income, that does not mean you can use the per-country calculation as long as U.S. statutory rules require use of an overall limitation.

An aspect of the French protocol that deals with a serious source rule problem involves the U.S. citizen resident in a treaty country who receives income taxed in that country on a residence basis, and who is taxed in the United States on the basis of citizenship. Both countries would tax income from U.S. sources. The underlying question is which country is going to give double taxation relief with respect to such income. The mechanism of the protocol to the French Treaty produces a sharing of tax revenue by the U.S. and France. In the case of services rendered in the United States by a U.S. citizen residing in France, the protocol provides for an exemption on the French side. In the case of U.S. source dividend and interest income, the protocol establishes the U.S. right to impose tax at a rate up to the withholding tax rate imposed on U.S. source dividends and interest paid to a French resident who is not a U.S. citizen. France will credit the U.S. tax. In addition, the treaty further changes what would be the effect of U.S. statutory law to state that an additional amount will be treated as French source income. The French may tax that amount and the U.S.will give a foreign tax credit for that French tax. A further residual right of taxation is reserved for the U.S. on a citizenship basis.

## Branch of U.S. company

A somewhat similar problem arises in the case of a foreign permanent establishment of a U.S. company subject to tax abroad and subject to tax in the United States on its world-wide income. Resolution of double taxation requires the efforts of two countries negotiating a treaty to reach some agreement on which country will give double taxation relief on U.S. source income as well as for third country income. Here a variety of factors come into play, including (i) the effect of the non-discrimination article in the treaty, (ii) whether the permanent establishment is unilaterally given foreign tax credits in the foreign country on what that country considers foreign source income, and (iii) whether there should be either the granting of full tax relief including a credit for U.S. tax imposed on a nationality basis or a refusal to provide credit to a U.S. company forcing it to rely on the consequences of the overall limitation. I would raise the question as to how a treaty resolution compares with the U.S. legislative rule in Internal Revenue Code Section 906 where the U.S. unilaterally provides a foreign tax credit to a foreign corporation's permanent establishment in the United States with respect to the foreign source, as the U.S. defines it, effectively connected income of the permanent establishment taxed by the U.S. I am unaware of any other country that provides, by internal law, for such a tax credit. The question raised at the time Section 906 was adopted was, suppose there is a foreign branch in the United States of a foreign company that receives income subject to foreign tax and to U.S. tax; is the branch entitled to a foreign tax credit if the basis for the foreign tax is the branch's home country's taxation of world-wide income? The United States position was that the U.S. should provide a credit for the foreign tax in that case on foreign source income, but not for the foreign tax on U.S. source income. The granting of credits for a permanent establishment is not an answer that is readily adopted by other countries, even in tax treaty negotiations. The problem of double taxation of permanent establishments on third country income remains an unresolved treaty question.

Finally, with regard to the Internal Revenue Code Section 861 type of allocation of expense rule, there is virtually no real coverage of the problems under the treaties except where the allocation matches a Section 482 intercompany pricing allocation. The national reports indicate that there has not been much analysis of this problem in most countries, nor is there even general recognition of it as a problem or an issue. In our wisdom, or zeal or misapprehension, the United States has gone quite a long way in identifying this allocation issue as one affecting international taxation, and it may become an active area in future treaty considerations. But I think right now, when one is only beginning to identify some of the problems about the source of income, we are a long way from knowing what sort of treaty rules one might see develop regarding expenses.

# TAX GLOSSARY

by H.W.T. PEPPER *

**THINLY-CAPITALISED COMPANIES (CORPORATIONS)** - Under a corporation tax regime where classic corporate income and the dividends paid thereout are both taxed without imputation relief (see ECONOMIC DOUBLE TAXATION), it is more favourable for a company to minimise its equity capital and rely heavily on borrowed money. Interest paid on loans, debentures, convertible stock, etc. is normally deductible in determining profits whereas dividends on equity shares are merely regarded (as taxable) distributions of profits.
In double taxation treaties interest on borrowed money is often given favourable tax treatment (exemption, or abatement of the tax rate) where the interest is payable to a non-resident. An enterprise, set up with foreign capital, may, thus, also have a tax "incentive" to finance its operations with loans instead of equity capital.
This form of tax avoidance which results in companies having an abnormally low proportion of equity capital is usually countered by legislation which deems a certain part of the loan interest to be dividends or distributions of profit.

**THIRD-TIER FOREIGN TAX CREDIT** — A U.S.A. taxpayer who owns 10 percent or more of a foreign corporation (regarded as a "first tier" foreign corporation) is entitled to relief for tax paid abroad by that corporation (regarded as, or "deemed", paid by the taxpayer) in computing his tax on income from that corporation. If the foreign corporation in turn owns 10 percent or more of another ("second-tier") corporation the former is regarded as having paid the proportionate part of the latter corporation's foreign tax. Finally, if the second-tier corporation owns 10 percent or more of another ("third-tier") corporation the second-tier corporation receives relief for its deemed-paid share of the third-tier corporation's foreign tax, which thus passes at third-hand to the original taxpayer. There is no relief for fourth-tier or more remote subsidiaries tax paid overseas.

**THRESHOLD, TAX** — See TAX THRESHOLD.

**TILLAEGSSKAT** — (Denmark) Additional tax, Surtax.

**TIMBER PROFITS TAX** — A tax, additional to ordinary income tax, imposed on the profits of timber-felling or logging concerns in Malaysia. The tax is intended to fall more heavily on the profits from the richer stands of timber, as a form of RESOURCE RENT TAX (q.v.).

**TIME APPORTIONMENT RELIEF** — Under the U.K. capital gains tax rules (which commenced 6 April 1965), a gain which consists of the excess of disposal proceeds of an asset acquired before 6 April 1965 over its original cost may be apportioned so that only the proportion on a time basis which accrued between 6 April 1965 and the date of disposal is charged with tax.

**TIME LAG** — See DECALAGE D'UN MOIS.

**TIME LIMITS** — Apart from the routine administrative time limits imposed on taxpayers for filing returns, making payments, etc. (which limits may usually be extended for adequate reasons), there are also legal limits for making assessments and claiming refunds. See STATUTE OF LIMITATIONS.

**TIN PROFITS TAX** — A tax, additional to income tax, imposed on the profits of tin-mining concerns in Malaysia, which falls more heavily on those mining the richer deposits and may have no impact at all on those working marginal deposits. The tax is in the nature of a RESOURCE RENT TAX (q.v.).

**TITHE REDEMPTION ANNUITIES** — Annual payments under the British Tithe Acts of 1936 and 1951. The payments, which were a charge on certain lands, replaced TITHES (q.v.) and 5/6 of the payments are deductible for income tax purposes. The annuities were extinguished on 1 October 1977.

**TITHES** — In Britain and many other countries, tithes were a charge (theoretically of one tenth) upon the produce of certain land for the benefit of the church. In 1936 tithes were converted in Britain to fixed annual payments known as TITHE REDEMPTION ANNUITIES.

**TOLDAFGIFT** — (Denmark) Customs duty.

**TOLL GATE CHARGE** — In the U.S.A., certain company liquidations, reorganisations, and incorporations involving foreign affiliates require an advance ruling from the U.S. Treasury to ensure qualification for non-taxable or tax deferred status. In some circumstances the applicant may be required to pay, as a condition of obtaining the ruling, what is known as a "toll gate charge", which is a kind of tax on the property or shares being transferred.

**TOLLS** — See ROAD TAX, ROAD TOLL.

**TOP-SLICING RELIEF** — The term applied to relief granted under a graduated direct tax regime to avoid excessive tax being charged where, because of "bunching", an unusually large amount of income or gains would fall into a single tax year. The relief given is usually in the form of allowing a notional spread of the lump sum involved over a period of years. Relief in Britain is granted in respect of such items as GOLDEN HANDSHAKES (q.v.) where the compensation for loss of employment is otherwise taxable when payable, certain gains from insurance policies, and in respect of premiums on leases.

**TOTALISATOR TAX** — A totalisator is an apparatus through which bets may be made at a race course. The odds are not predetermined but are calculated by the totalisator for the winning horses on the basis of the total amounts actually staked on all the horses in a particular race. Where such betting is taxed it is a simple matter for the apparatus to calculate its own tax bill and take it into account in reckoning the net winnings, and the tax collection process is a very simple one.

**TOURIST TAX** — Taxation on tourists is generally restricted to a service charge or airport tax levied when the tourist leaves the country by air, but indirect

* With the assistance of the staff of the International Bureau of Fiscal Documentation.

taxation in the form of a room tax or a hotel and restaurant tax may be applied to the grade of hotels and restaurants commonly used by tourists so that the tax falls mainly on that class of taxpayers. (See also HOTEL TAX, ROOM TAX, TRANSIT TRAVELLERS TAX, AIRPORT TAX, SECURITY TAX.)

**TRADE ASSOCIATIONS** — It is fairly usual to treat trade associations as mutual organisations which are not taxable on any surplus transactions with members (see MUTUALITY PRINCIPLE), provided the association has duly registered under any statutory requirement governing the administration of such organisations. Where such an association makes a special levy on members for some capital project, or for some joint contribution for a purpose which would not carry a right to tax deductibility, arrangements may sometimes be made for the association to account for tax on such contributions as an alternative to disallowances being made in computing the profits of all the individual contractors.

**TRADE UNIONS** — It is usual to make special income tax arrangements regarding trade unions which have been duly registered under trade union legislation. Generally speaking, income tax will not be charged on the surplus of receipts from members over outgoings (see MUTUALITY PRINCIPLE) and tax exemption is sometimes given in respect of the investment income of the union, particularly where its constitution embodies activities similar to those of a friendly society.

**TRADER, SMALL, RELIEF FOR** — See SMALL TRADERS.

**TRAINING LEVY** — A training levy may be imposed by a government where the government itself is largely responsible for training workers for certain types of industrial, mining, or agricultural tasks for which there is a demand for skilled workers. A refinement is to allow rebates from the levy to employers who train their own workers to an acceptable level of skill.

**TRANCHE SYSTEM** — The method of levying tax at graduated rates whereby the tax rate increases on successive tranches, or slabs, of income or capital. The system is commonly used in graduated personal income taxes, death duties, and gift taxes.

**TRANSACTION TAXES** — Taxes levied on commercial transactions, usually at a low rate percent on a multistage basis. An example was the 0.6 percent tax levied on transaction in Belgium before the switch to V.A.T. Such taxes are really CASCADE TAXES (q.v.).

**TRANSFER PRICING** — A method whereby an international trader may adjust prices for his goods, manufactured in one country and sold in others, so that an undue proportion of total profits is allocated to the country with the lowest taxes. See also ARM'S LENGTH PRICE.

**TRANSFER TAXES** — There are various examples of transfer taxes in operation — see CAPITAL TRANSFER TAX, CONVEYANCE TAX, STAMP DUTY — that in Italy is levied at 10 percent on the value of the land when land and buildings are transferred. The tax is also payable on the value of the buildings concerned where these are not subject to V.A.T. (See also CAPITAL TRANSFER TAX, GIFT TAX, STAMP DUTIES, TRANSMISSION TAX.)

**TRANSIT TRAVELLERS TAX** — A tax, which has occasionally been charged on tourists who visit a country only briefly, e.g., those making a call of a day, or part of a day as passengers in a cruise liner, usually as a contribution towards the cost of providing facilities for such tourists. In some instances the "tax" takes the form of a landing charge. In general such levies are not usually recommended by those advising on tourism, on the grounds that tourists tend to resent even a small tax which has to be paid in order that they may visit a country. Where, however, a global charge is payable by the visiting cruise ship, instead of by individual passengers, the levy, which is justifiable, is usually collected smoothly, on the UNMERKLICHKEIT (q.v.) principle. (See also AIRPORT TAX, SECURITY TAX.)

**TRANSITION ADJUSTMENTS** — It is usual to make special arrangements on the introduction of a new tax in respect of existing taxes. For example, with the introduction of unified personal tax in Britain in 1973/1974, taxpayers were allowed extra time in which to pay the surtax due from them in respect of 1972/1973 incomes which would normally have been payable during 1973/1974. When V.A.T. is substituted for another form of sales tax, it is usual to make transitional arrangements to allow relief against V.A.T. for sales tax embodied in stocks of commodities which are in hand at the commencement of V.A.T.

**TRANSPORTATION TAXES** — Taxes levied on vehicles using public highways, ships, boats and barges using canals, rivers and waterways maintained by the government, and upon aircraft using airports. Examples include the historical LOCOMOTION TAXES (q.v.) in Britain, the federal excise tax on transport in the U.S.A., and the inclusion of charges for the carriage of passengers and freight in certain V.A.T. systems. (See also ROAD TAX, ROAD TOLL, VEHICLE TAX.)

**TRANSMISSION TAXES** — Taxes (1) on the transmission of assets by gift or by death (see GIFT DUTIES and DEATH DUTIES), and (2) on the transport of oil, etc. by pipeline.

**TRAVEL TAX** — Travel is a subject for taxation in several countries: Japan has a 10 percent levy on the higher classes of passenger travel, the U.S.A. has a 10 percent Federal excise on inter-State travel, and Israel taxes its residents on the cost of foreign travel. The term "travel tax" has also been given to the 2 percent levy introduced in 1974 on air package holidays to build up a fund (known as the Air Travel Reserve Fund) to compensate holiday-makers who suffered loss through the financial failure of their travel agents. Several such failures had occurred in 1974 after the sharp increase in world oil prices added materially to the cost of (pre-paid) air transport. Once sufficient funds had been collected, the levy was suspended and the need for it has since been reduced by a system of bonding operated by the Association of British Travel Agents in conjunction with the Civil Aviation Authority.

**TREATY, DOUBLE TAXATION** — See DOUBLE TAXATION.

**TREE AND FRUIT CONCEPT** — See FRUIT AND TREE.

**TRIPLE ASSESSMENT** — A tax levied in 1798 in Britain by Pitt consisting of a levy of 3 times the previous year's tax with a ceiling of 10 percent on income and charged upon (a) those who kept carriage or saddle horses and (b) those who paid inhabited house duty, or window tax. The law was an immediate precursor of income tax. (See also EXTERNAL INDICIA OF WEALTH.)

**TRUST** — A trust has been defined as the relationship between persons and property under which property is vested in persons known as trustees, who control the property for the benefit of persons known as beneficiaries. A trust may be set up by a living person, known as a settlor, or under a Will after his death, by the written instructions of a testator. For tax purposes, where the income of a trust is fully distributed to the beneficiaries most countries' tax codes "look through" the trust and tax the beneficiaries directly on their shares of the income. Where trust income is accumulated the tax treatment varies according to the nature of the trust provisions and the tax law.

— *Accumulation and Maintenance Trust:* A trust, the income of which is accumulated for the benefit of a beneficiary, usually a child, and usually for a period of up to 21 or 25 years. A normal provision is that money may be disbursed before attainment of the specified age, but only for maintenance of the child. Such disbursements will form income of the beneficiary while the remaining trust income will usually be taxed at a flat rate (in the U.S. currently at 48 percent).

— *Discretionary Trust:* A trust in which the trustees have absolute discretion as to whom among usually a large number of potential beneficiaries should actually benefit. Where such a trust is used for tax avoidance, the trustees, though not bound to do so, usually heed the suggestions of the settlor as to who should in practice benefit. Anti-avoidance legislation has for the most part destroyed the value of such trusts for tax avoidance, e.g., in the U.K.

— *Sprinkler (Sprinkling) Trust:* The term used in the U.S.A. for DISCRETIONARY TRUSTS (q.v.), presumably because the trustees have power to "sprinkle" the benefits upon which beneficiaries they think fit.

— *Charitable Trust:* A trust set up for purposes beneficial to the public, e.g., for the relief of poverty, the advancement of education and religion, and other objects beneficial to the community. Donations to a charity may be exempt from gift or capital transfer taxes, capital gains tax. (See also CHARITY, DONATIONS, EXEMPTION, INVESTMENT TRUST, REGULATED INVESTMENT CORPORATION, UNIT TRUST.)

**TRUSTEE PRINCIPLE** — The principle that taxpayers who deduct or withhold income taxes from other taxpayers, or who are registered for the payment of sales taxes and include a sales tax element in the price charged to their customers, are all collecting tax on behalf of the tax department to whom they are responsible, much as a trustee is responsible to the beneficiaries of a trust, for remitting and accounting for the tax thus collected.

**TURNOVER TAXATION** — The word "turnover" nowadays usually is synonymous with "sales" or "recipts", but "turnover tax" is also a term sometimes given to the cascade taxation which applies to all stages of manufacture and distribution. The turnover tax in Eire, however, was a single stage retail sales tax upon the sales or turnover of retailers (since replaced by V.A.T.). The word "turnover" has another connotation in that it sometimes means the number of times a trader "turns over" his capital or trading stock during the year, but this is now an old fashioned use of the word.

**TURNPIKE** — See ROAD TOLL.

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**UDBYTTESKAT** — (Denmark) Dividend tax.

**UMSATZSTEUER** — (German Federal Republic) The value added tax.

**UNA TANTUM** — The term used in Italy for FORFAITAIRE (q.v.) treatment of certain commodities in the context of CASCADE sales taxation, which preceded the present V.A.T. (IVA).

**UNDEPRECIATED CAPITAL COST** — A term used in the Canadian tax code and defined as the original cost to the taxpayer of a depreciable asset less the depreciation allowances of previous years, plus subsequent additions to the asset and less subsequent disposals. To the uninitiated the term seems something of a misnomer since in the calculation the original cost *is* depreciated! Where the sale or salvage proceeds of the asset exceed the undepreciated capital cost the excess is recaptured (see also BALANCING CHARGES). A capital gains tax charge would only arise if sale proceeds exceed the original cost.

**UNDERLYING TAX** — Tax which is charged upon corporate income out of which dividends are paid, but which does not appear as a direct deduction or withholding from the dividend itself.

**UNDISTRIBUTED PROFITS TAX** — A tax on corporate profits which have not been distributed to the shareholders. There are various systems of taxing corporate profits and distributions out of these profits; for example, in Britain attempts were made at one stage through the imposition of a discriminatory profits tax to discourage distributions as an anti-inflationary measure — distributions were at one time subjected to a 27.5 percent rate while undistributed profits were only charged at 2.5 percent. On the other hand, the corporate tax system of the Federal Republic of Germany involves the taxing of undistributed profits at a much higher rate than distributed corporate profits. Both in Britain and in Germany dividends are also taxed in the hands of the recipients. The German system of taxing profits is designed to encourage corporate distributions and thus a healthy capital market, since there is a fiscal "penalty" on the retention of profits. In principle, it is considered that a company which pursues a full distribution policy and the obtaining of fresh finance by rights issues and thus submits its operations to scrutiny by investors should be more efficient than a company which merely ploughs back retained profits without submitting itself to periodical stock market tests.

Where a company had retained profits over the entire period of its operations and is then wound up, tax avoidance could take place through the distribution to shareholders of accumulated profits in "capital" form. Accordingly, most countries in their tax law provide for the additional taxation of accumulated undistributed profits distributed to shareholders on company liquidations. In the case of CLOSE COMPANIES (q.v.) there is usually also an annual requirement of minimum distributions to shareholders, failing which the tax law may deem such distributions to have been made and charge tax accordingly.

[to be continued]

 

# IFA NEWS

## Paris Congress 1980
## Results of the discussions

At the end of the Paris Congress of IFA a resolution was adopted on Subject I and with respect to Subject II only a summing up was issued.

### SUBJECT I:

### Dialogue between the Tax Administration and the Taxpayer up to the Filing of the Tax Return

*Resolution* (translation*)

Relations between the tax authorities and taxpayers have undergone a considerable change during the last decades in almost every I.F.A. member country. This is due to the growing number of taxpayers, the increased complexity of tax legislation and the increase in the tax burden. In addition to formal, legal relations, a dialogue of a rather less formal nature has been developed, starting well before the filing of the tax return.

Congress is of the opinion that such a dialogue may be of great interest, in that it allows the taxpayers, on the one hand, to obtain more knowledge of his rights and obligations in fiscal matters, and, on the other hand, the tax authorities can reach a better understanding of real situations and conditions. In the opinion of Congress, a satisfactory dialogue between the tax authorities and the taxpayer, prior to preparing and filing the return, is in many cases, an essential condition for creating a favourable tax climate and a cost-effective method of tax collection.

In order to ensure the satisfactory organisation of the dialogue, measures should be taken to inform and protect the taxpayer, and ways found of preventing practical and legal errors, as well as tax fraud. These measures would concern the tax authorities, the taxpayers, the taxpayers' representatives and the legislators.

Congress makes the following recommendations:

1. Within the framework of the dialogue the tax administration should provide the taxpayer with full and clear information as to his rights and obligations. Information of general interest, especially administrative directives, should be readily accessible to all concerned. As far as possible, directives should be elaborated through cooperation between the tax authorities and qualified representatives of taxpayers. Points of law included in any published directives should be respected by the tax authorities and never withdrawn with retroactive effect.
2. Congress considers that a procedure for obtaining an advance ruling is an important element in a satisfactory dialogue. The subject was discussed in the Congress in London of 1965, and copy of the Resolution is attached hereto.
3. It is a condition of establishing a satisfactory fiscal climate that the taxpayer has an essentially positive attitude towards the collection of tax and compliance with the procedures. It is therefore important that schools and universities provide a general understanding of the aims of public finance and the role of taxes. Conversely, officials of the Tax Administration should be trained in the dialogue with taxpayers.
4. Within the framework of the dialogue between the authorities and the taxpayer, tax advisers play an important intermediary role. Because of the important position of the advisers, rules or practices should be elaborated in order to guarantee technical competence as well as correct professional standards.
5. Finally, the legislator has a great responsibility for the satisfactory working of the dialogue between the authorities and the taxpayer. This dialogue is made particularly difficult by the existence of regulations which are complex and frequently modified. The simplification of the regulations would create the essential basis for a more successful dialogue between the authorities and the taxpayer.

### APPENDIX

**The 19th Congress in London – 1965**

**Resolution Subject II** (original version)

*Advance Rulings by the Tax Authorities at the Request of a Taxpayer*

The Congress points out that the complexity of fiscal legislation is constantly increasing in all countries and for this reason it has become increasingly difficult for the taxpayers to obtain reliable information concerning the application of tax laws, which is prerequisite for all financial planning. This situation, combined with high tax rates, constitutes a serious problem of legal security. Therefore it is important that taxpayers be provided with an opportunity to obtain an authoritative opinion on the meaning of the law before taking measures, the fiscal consequences of which are uncertain.

The Congress finds that the State, which must demand farreaching cooperation from taxpayers, should ensure that the position of taxpayers is facilitated in this respect. This would at the same time establish a better relationship between the fiscal authorities and the taxpayers.

The Congress, noting with satisfaction that taxpayers have in some countries been accorded by legislative means an opportunity to request advance rulings and that the fiscal authorities in

* The original version is in German.

many countries answer the inquiries of taxpayers without a statutory to do so, has decided to make the following recommendations to improve the position of taxpayers:

1. Taxpayers should be offered an opportunity to obtain within a reasonable time advance rulings concerning the tax consequences of planned bona-fide transactions, at least if they are of material significance to the taxpayer or of general legal importance.
2. The opportunity to obtain advance rulings should not be limited to special problems nor to certain taxes, but in principle it should be possible to issue advance rulings concerning all taxes.
3. The fiscal authorities should adhere to the position taken in an advance ruling upon which a taxpayer has relied in good faith. Any subsequent change in the law should be applied as far as possible without retrospective effect.
4. It is desirable that there should be a right to appeal against advance rulings in those countries where this is administratively and legally practicable.
5. It is desirable that a method of publication of advance rulings should be devised, to ensure the uniform application of the law.

## SUBJECT II:

### Rules for determining income and expenses as domestic or foreign

*A summing up of the Congress discussion*
(original version)

1. Most countries have established in their domestic tax laws rules to determine, in respect of different categories of income, the rights of the State of source and those of the State of residence, domicile, or citizenship.
2. However, the rules determining income as domestic or foreign often reveal wide disparities between countries in their definition and operation. In the absence of any generally accepted principles, such disparities may lead to problems of double taxation.
3. Moreover, there is no generally recognized basis for allocating expenses to domestic and foreign taxable income in order to determine net income liable to tax or subject to double tax relief. This also may lead to problems of double taxation.
4. It is now accepted that for the continued development of world trade and investment, every effort must be made to adapt domestic (unilateral) tax laws so that rules as to the source of cross-border income and the allocation of expenses are harmonized.
5. The Congress has discussed a number of different approaches to determining income as domestic or foreign and the lack of harmony in domestic tax laws is particularly evident in this respect as to business income, income associated with transfers of technology and income from the rendering of services.
6. The practical solution to taxation conflicts arising from unharmonized domestic laws is seen in the conclusion and revision of an increasing number of bilateral double tax conventions, having regard to the efforts of international bodies in establishing acceptable convention guidelines. These conventions should achieve a compromise between contracting States in their differing approaches to recognizing income as domestic or foreign.
The problem of expense allocation to cross-border income can also be resolved through bilateral double tax conventions. Such conventions may use alternative means of recognizing expense allocation either by permitting the deduction of reasonably attributable expenses or by limiting the rate at which taxes may be levied.
States should cooperate so that the same expenses be considered applicable to a given item of income by both the country of source and that of residence, domicile or citizenship of the taxpayer.

# Conference Diary

## JANUARY 1981

*The Economist:* Joint ventures in China (including: Some practical tax case studies), London: January 29; Zürich (Switzerland): February 2 (English).

*European Study Conferences:* Direct investment in oil and gas and related tax planning, London, January 27 (English).

## FEBRUARY 1981

*Management Centre Europe:* International Tax Management (including: Inter-company pricing: licensing, service fees) (Seminar), Brussels (Belgium), February 12-13 (English).

*Practical Conferences:* Tax avoidance and evasion, London, February 4 (English).

## MARCH 1981

*Management Centre Europe:* Managing and Developing Foreign Subsidiaries (including: Tax in international operations), Brussels (Belgium), March 4-6 (English).

## APRIL 1981

*Management Centre Europe:* Fourth MCE International Tax Conference. Chairman: Prof. J. van Hoorn Jr., Co-Chairman: A.G. Davies C.B.E. Main subjects: Transfer pricing: Government and business views on tax avoidance; Taxation of international leasing; small meeting groups directed by members of the faculty, Munich (German Federal Republic), April 8-10 (English).

## SEPTEMBER 1981

*35th Annual Congress of I.F.A.:* I. Mutual agreement procedure and practice; II. Unilateral measures to prevent double taxation, Berlin (German Federal Republic), September 21-25 (English, French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

European Study Conferences Limited, Kirby House, 31 High Street East, Uppingham, Rutland, Leics. LE15 9PY.

International Fiscal Association (I.F.A.): General Secretariat, Woudenstein, Burgemeester Oudlaan 50, P.O. Box 1738, 3000 DR Rotterdam (the Netherlands).

Management Centre Europe: Avenue des Arts 4, B-1040 Brussels (Belgium).

Practical Conferences Administration Offices: 270 Cartechatch Lane, Enfield Middlesex EN1 4BG (United Kingdom).

The Economist (Conference Unit): Mrs. Marion Bieber, 25 St. James Street, London SW1 1HG (United Kingdom).

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