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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.

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d. by producing publications;
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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 development. *Supplementary Service to European Taxation* is a loose-leaf reference work.

The loose-leaf series *Guides to European Taxation* comprises "The Taxation of Patent Royalties, Dividends, Interest, in Europe", "The Taxation of Companies in Europe", "The Taxation of Private Investment Income", "Value Added Taxation in Europe" and "Taxation in European Socialist Countries".

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 other 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 "The Taxation of Patent Royalties, Dividends, Interest, in Europe", "The Taxation of Companies in Europe", "The Taxation of Private Investment Income", "Value Added Taxation in Europe" et "Taxation in European Socialist Countries".

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The I.F.A. was founded on the 12th of February 1938 by tax experts of a number of countries. Purpose and working-method are defined as follows in the Articles:

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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.

Plan of Action – Article 3
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 Amsterdam; e) by all other appropriate methods.

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of the January 1982 issue

INHALTSVERZEICHNIS

SOMMAIRE

The Financing of the Southern Region and other Regional Governments of the Sudan

by John F. Due and Jean M. Due*

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I. INTRODUCTION

The Southern Region of the Sudan was given a high degree of autonomy in 1972, as a move to end the seventeen-year civil war. The Southern Region (SR) has its own elected assembly, cabinet, and president, who is also vice president of the Central Government. Most governmental functions in the South, other than defense, foreign relations, and services of a national character, such as the post office, were given to the SR government. The SR is relatively isolated from the rest of the country, and differs sharply in other respects; it is primarily non-Moslem, with English, not Arabic, as the common language. The semi-subsistence typically tropical agriculture, the basis of the livelihood of most of the population, contrasts with the irrigated and dry land mechanized farming of the rest of the country.

It is the purpose of this paper to review the methods of financing of the SR, and the significance that this financing may have for the newly-created (December 1980) regional governments in the rest of the country.

* The authors are Professor of Economics and Professor of Agricultural Economics at the University of Illinois, Urbana. They are indebted to the officials of the government of the Southern Region of the Sudan for their assistance, and particularly to Dr. David Bassiouni, Director General of Agriculture of the Southern Region.
This paper is based upon a study of the financing of agricultural development projects in the Southern Region for the government of the Southern Region, under World Bank auspices in 1980, and additional study in Khartoum in 1981.

II. THE TAX SYSTEM OF THE CENTRAL GOVERNMENT

The financing of the subordinate units in a Federal system must be considered in the light of the central government tax structure. A brief review will suffice. Table 1 provides the figures for 1979/80 and the revised budget figures for the 1980/81 fiscal year (ending June 30, 1981). The relative figures have not changed greatly over the last decade. There are several significant features. The relative reliance on direct taxes is one of the lowest in the world, even among developing countries. The percentage reliance on customs duties is very high by present day standards, nearly half of the revenue raised from this source. The figure is, however, somewhat misleading, since imports by government, which constitute about half of the total, are subject to the duties.

A few major characteristics of the tax system can be summarized.

A. Direct taxes

The direct tax system is schedular; the most important revenue element is the business profits tax, applied to all businesses, corporate and noncorporate. The rate ranges from 15 to 60% on resident individuals, 25 to 60% on corporations and non-resident individuals. The personal income tax, collected largely through withholding, applies only to wage and salary incomes, with rates from 15 to 70%, and a flat LS 1,000[1] exemption regardless of family size. Wives are treated as separate taxpayers. The other two elements in the income tax structure, land rent (taxed at the same rates as business profits) and capital gains, with rates ranging from 5 to 25% (40% on limited companies), are of minor revenue importance.

B. Indirect taxes

1. *Customs duties*

The tariff is very complex, with over 25 ad valorem rates and a number of specific rates. The basic rate is approximately 40%. Exemptions are very limited, to medicine, a few foods, and some items used in farming.

2. *Excises*

There is an unusually wide range of excises – 33 as of 1981 – applying to most domestic production, with compensating levies on imports, called consumption duties, on five major commodities. The majority of the excises have ad valorem rates, but some are specific.

3. *Development tax*

In 1974-75 the government introduced a general sales tax at the manufacturing level, called a development tax. The rate is currently 5%. Exemptions are very limited, although unprocessed foods are not reached. At times the levy has applied to imports as well, but not currently; it does apply to exports, an unusual policy.

There is also a 10% tax on specified services, including hotels and restaurants, called a sales tax.

TABLE 1

Current revenue sources, Democratic Republic of the Sudan 1979/80 – 1981/82

	Revenues, millions of LS			*Percentage of total tax revenue*		
	1979/80	1980/81 [1]	1981/82 [2]	1979/80	1980/81	1981/82
Direct taxes	79.8	100.0	130.0	17	17	16
Indirect taxes:						
Customs duties [3]	229.2	254.7	381.0	48	44	48
Excises [4]	100.3	122.5	182.2	21	21	23
Development (Sales) tax	36.5	33.0	45.0	8	6	6
Sales ((Services) tax	–	2.0	5.0	–	neg	1
Sugar monopoly	20.2	0	0	4	–	0
Total indirect	392.8 [5]	412.2	613.2	81	71	78
Export duties	9.7	66.0	54.0	2	12	6
Total taxes	482.3	578.2	797.2	100	100	100
Nontax revenue	106.9	118.4	251.0			
Total current revenue	582.5	756.6	1048.0			

1. Revised budget figures.
2. Budget figures.
3. Including defense tax and exchange fund.
4. Including consumption duties and stabilization fund excise.
5. Including miscellaneous.

Source: Sudan, Ministry of Finance and National Economy.

1. 1 LS = $1.25.

4. *Export duties*

There is a substantial list of export duties, all with ad valorem rates, most between 5 and 15%. The major one, revenue wise, on cotton was eliminated in 1980 to increase cotton exports.

The tax system has undergone little basic change for several decades, apart from the introduction of the development tax.

III. THE SOUTHERN REGION (SR)

The SR contains about 650,000 square kilometers, about one-fourth of the total area of Sudan, and is somewhat larger than Kenya. The population is about three and three-fourths million, about one-fifth of the country's total population. The per capita income data in the Sudan are by no means accurate; the figure for the South is estimated to be $ 150, or one-third the average for the entire country. The South is highly dependent on agriculture, including livestock. Most cultivation is semisubsistence, with shifting cultivation comparable to that of tropical Africa. Rainfall is adequate without irrigation. Dura, a form of sorghum, is the most important food crop, plus maize, millet, groundnuts and sesame. Currently there is little production of previous export crops: cotton, coffee and tobacco.

Recurrent expenditures of the SR government are made for a number of purposes: the largest items are education and agriculture and natural resources, each 13% of the total, followed by roads, health and welfare, and general administration. The provinces of the Region – there are currently six – concentrate their activities on education, health and welfare, and prisons, which together account for about 80% of their total spending (1980). In the development budget, agriculture and health are the major items (each 17%), followed by communications and roads. The development budget totals are typically far in excess of the actual amounts spent, which are restricted by availability of funds. At the provincial level, agriculture, industry, and transportation are the chief elements in the development budget, agriculture alone reaching nearly 50% in Western Equatoria province.

A. The financing of the Southern Region

Table 2 shows the overall recurrent budget data for 1980/81; grants from the Central Government constitute two-thirds of the total. In other words, the SR is far from being autonomous in terms of financing its activities.

The tax structure of the SR government is very complex. There are three distinct types of levy:

B. Taxes imposed by the Central Government, but collected by the Regional Government and retained for its own use

These consist of the income taxes plus the stamp duty. For a time the provinces collected the business profits tax on small firms and retained the revenue; in more recent years SR government has collected the tax.

TABLE 2

Summary of the recurrent budgets of the Government of the Southern Region of the Sudan in LS, 1977/78 – 1980/81.*

	1977/78	1978/79	1979/80	1980/81
Recurrent expenditures:				
Own recurrent expenditures	23,393,680	28,138,624	34,236,068	38,203,407
Transfer to development budget	2,400,000	2,500,000	2,500,000	2,500,000
Transfer to the provinces	8,935,460	9,300,000	19,800,000	20,707,000
Total	34,629,140	39,939,624	56,536,068	61,410,407
Recurrent revenues:				
Tax revenue	8,427,400	11,412,000	14,370,700	15,053,700
Nontax revenues	5,601,140	5,026,624	6,165,368	6,356,707
Total, own revenue	14,028,540	16,438,624	20,536,068	21,410,407
Grants from Central Government [1]	20,800,000	23,500,000	36,000,000	40,000,000
Total	34,828,540	39,938,624	56,536,068	61,410,407

1. Including funds transmitted to the provinces.

* *Source:* Democratic Republic of the Sudan, Southern Region, ***Budget Speeches,*** respective years, 1977/78–1980/81.

C. Taxes imposed and collected by the Central Government but the revenue shared with the SR

Most are indirect taxes, but customs duties are not shared:

a. Excises. The revenue of three excises, cigarettes, beer and liquor, are shared with the SR, on the basis of destination. These are collected at the factory.

b. Consumption duties, the counterparts of certain excises on imports. The revenue of these is shared with the SR government on the basis of destination of the goods.

c. Export duties, on goods exported from the SR to foreign countries. As such exports are now negligible, this is not a significant source of revenue.

D. Taxes imposed and collected by the Southern Region Government

The SR government has imposed a large number of taxes, which yield nearly half of its total tax revenue.

a. Surcharge on imports. When the Central Government removed comparable taxes in 1979-80, the SR imposed a 10% surcharge on imports into the region from other countries, collected by SR personnel at the borders (most of the imports come in via Kenya or Uganda, and some from Zaire). Ultimately the plan is that this tax will be collected by Sudan Customs.

b. A number of separate levies called development taxes.

1) On incomes, with rates from 1 to 11%, collected by the SR government in conjunction with the income tax. Most is collected from employers monthly.
2) On license holders, as for example on motor vehicles, LS 1 a year.

3) On profits of government corporations, 5%. The tax yields little, as most are not profitable.
4) Taxes upon the sales of a number of commodities and the provision of services:
   i) Sugar – 5 piastres (p)[2] per rottle, paid to the tax office to obtain a certificate to buy sugar. Sale of sugar is controlled.
   ii) Petrol and diesel fuel – 5p. per gallon; collected from the seller.
   iii) Telegrams – 5p. each.
   iv) Hotels – 10%.
   v) Airport embarkation – LS 1.
   vi) Dates – LS 20 per bag (100 kg).
   vii) Sale of products of mechanized farms: from Renk, dura (10p. per sack), sesame (50p. per sack); from Aweil, rice, grade 1, LS 3 per sack, grade 2, LS 2, grade 3, LS 1.
   viii) Cigarettes, which are produced at the Haggar cigarette factory in Juba, 2 p. per 10 cigarettes.
   ix) Taxes on certain imports:
   Vehicles – LS 35 on autos, LS 25 on heavy vehicles.
   Miscellaneous appliances – LS 5 to LS 20 each.
   Liquor – LS 1 per half litre.
   Coffee – LS 150 per ton.
   Tea – 8 p. per kg.
   These are collected at the border points, by the SR tax offices, with cooperation of the police and customs guards, with an attempt to catch goods smuggled in, as for example, at Yei, coffee from Zaire. Tax applies regardless of final destination.
   x) Crocodile skins, 5p. per inch.
   xi) Exports from the SR to foreign destinations:
   Fish.
   Salt.
   Soap.
   Edible oil.
   Ready made clothes.
   Dumuria and dabalan (types of textiles), 20% factory price.
   Utensils.
   Onions.
   Aspro (aspirin), 20% factory price.
   Bicycles and parts, 20% of export price.
   These are collected at border points on locally produced or imported goods when reexported.
   xii) Road tolls, on entrance into the Sudan of foreign registered vehicles. Present rates: truck, LS 35, with trailer, LS 70. Much of the revenue is collected in Nairobi on departure of the trucks for the Sudan.
   xiii) Contracts, made in the SR by firms located elsewhere and not subject to profits tax, LS 100 to LS 200 per LS 10 million.

c. Purchase tax on second hand motor vehicles.

d. Share of the profits of the sugar monopoly, classified as a tax, based upon total consumption of sugar in the SR as a percentage of the national total (4%), remitted by the Central Government.

Other taxes have been used in recent years. Until 1980/81 a 5% tax was applied to the construction cost of new Central Government capital projects in the SR; this was eliminated in the belief that it was hampering development. Until 1979, an education tax was imposed as a supplement to the tax on wages and salaries and license holders (comparable to the present development tax). This had replaced school fees, which were believed to be restricting school attendance.

The government has planned a sales tax, to apply to local manufacturing and to goods brought into the SR and resold, on the pattern of Kenya's manufacturers sales tax. But implementation has been delayed because of concern about administration.

Table 3 provides an overall picture of taxes and other nongrant revenues of the SR government for recent years. Table A-1 in the appendix provides a detailed breakdown of expected revenues by individual tax. As these tables show, over 40% of the tax revenue is collected for the SR by the Central Government. The most important tax revenue sources are the personal income tax; the share of Central Government excises and consumption duties; the surcharge on imports and exports, now locally collected but to be centrally collected; the personal income tax and the development tax on wages and salaries; the tax on sugar; and the profits of the sugar monopoly. Another major hoped-for source is additional revenue arising from revision of Decree 39, which allocated various taxes to the SR, to give the latter a share of excise taxes on additional commodities.

By usual definitions, about 17% of the total revenue other than grants is derived from direct taxes, the remainder from indirect. Since the Central Government revenue from direct taxes is 17% of its total tax revenue, on the whole in the SR the direct levies are providing less than 20% of the total tax revenue.

2. 100p. = LS 1.

TABLE 3

Major budgeted tax and other own-source recurrent revenues, Government of the Southern Region of the Sudan 1978–1981*

	Sudan LS				*Percentage from each source* [3]			
	1977/78	1978/79	1979/80	1980/81	1977/78	1978/79	1979/80	1980/81
Levied by Central Government:								
Collected by Regional Government								
Personal income tax	700,000	880,000	1,350,000	1,350,000	8.9	7.8	9.5	9.1
Business profits tax	200,000	280,000	280,000	280,000 [1]	2.5	2.5	2.0	1.9
Land and rental income tax	10,500	21,000	21,000	21,000	0.1	0.2	0.1	0.1
Capital gains tax	15,000	18,000	18,000	18,000	0.2	0.2	0.1	0.1
Stamp duty	45,000	120.000	125,000	125,000	0.6	1.1	0.9	0.8
Total	970,500	1,319,000	1,794,000	1,794,000	12.3	11.7	12.7	12.1
Levied by and collected by Central Government;								
Revenues to Regional Government								
Excise duties	1,700,000	1,100,000	1,100,000	1,100,000	21.6	9.7	7.8	7.4
Consumption duties	400,000	580,000	580,000	580,000	5.1	5.1	4.1	3.9
Export duties	6,000	6,000	6,000	6,000	0.1	0.1	neg.	neg.
Surcharge on imported goods [4]	–	–	–	2,300,000	–	–	–	15.6
Expected revenue from revision of presidential Decree No. 39	–	2,500,000	2,500,000	2,500,000	–	22.2	17.7	16.9
Total	2,106,000	4,186,000	4,186,000	6,486,000	26.8	37.1	29.6	43.9
Levied and collected by Regional Government;								
General Regional services and development tax	2,700,200	3,610,000	6,010,500	5,135,500	34.3	32.0	42.4	34.8
Sales tax	240,000	240,000	240,000	240,000	3.1	2.1	1.7	1.6
Purchase tax, used motor vehicles	6,000	6,000	6,000	6,000	0.1	0.1	neg.	neg.
5% tax, profits of public corporations	20,000	20,000	20,000	20,000	0.3	0.2	0.1	0.1
5% tax, initial construction, new Central Government	812,000	812,000	812,000	repealed	10.3	7.2	5.7	–
Miscellaneous	12,000	12,000	12,000	12,000	0.2	0.1	0.1	0.1
Total	3,790,200	4,700,000	7,100,500	5,413,500	48.2	41.6	50.1	36.6
Share, profits on sugar production [2]	1,000,000	1,080,000	1,080,000	1,080,000	12.7	9.6	7.6	7.3
Overall total, tax revenue	7,866,700	11,285,000	14,160,500	14,773,500				
Development charges and fees	5,601,140	5,026,624	6,165,368	6,356,707				
Miscellaneous	560,700	127,000	210,200	280,200				
Total non-grant recurrent revenue	14,028,540	16,438,624	20,536,068	21,410,407				

1. Total LS 700,000; LS 420,000 by provinces.
2. Included with tax revenues in the accounts, though not a tax.
3. Totals of tax revenue shown in the budget messages include items shown as miscellaneous revenue in this table: the figures shown in the budget messages are: 1977/78 – LS 8,427,400; 1978/79 – LS 11,412,000; 1979/80 – LS 14,370,700; 1980/81 – Ls 15,053,700.
4. Currently collected by the SR Regional Government. *

* Source: Democratic Republic of the Sudan, Southern Region, ***Annual Budget Speech*** for respective years; for 1980/81: ***Estimates of Revenues and Expenditures for Current Budget., 1980/81.***

E. Budgeted versus actual receipts

A major deficiency in the statistics is the lack of availability of actual revenue collected by fiscal year from various tax and nontax sources; the figures shown in Table 3 are the budget estimates. In the budget speeches, actual collections are shown up to May 1. Table 4 shows the budget figures for the three years 1977/78 through 1979/80, the actual amounts collected, as of May, and these actual collections projected by the authors of this paper through June 30 by simply adding one-fifth. Data are not available to do this by individual tax. It is obvious that much of the shortfall is due to the failure to obtain additional excise revenue on the basis of revision of Presidential Decree 39. The shortfall in the actual collections of nontax sources (fees, charges, etc.) is about as great as that on taxes.

F. Tax administration

Tax administration in the SR is in the hands of the Tax Department, in the Ministry of Finance and Economic Planning. There is a junior staff of 98 (1980) secondary school graduates, with the primary task of identifying commodities and making collections. Their training is provided in Juba (the SR capital Elementary accountancy instruction is provided at the Regional Accounting Training Center in Juba, established to provide this type of training for a number of government agencies. The senior tax staff, 20 in 1980, consists of university graduates, many with their degrees from the University of Nairobi. Several have been sent abroad for training, and the Head of the Tax Department has been seeking to find more satisfactory places for training.

Local tax offices are located at Renk, Wau, Malakal, Juba, Rumbek, Aweil, Yambio, Yei, and Kapoeta.

The Tax Department operates under serious difficulties: the lack of communication with the local offices, long distances, poor roads and shortage of motor fuel, inadequate background and training of personnel of the junior staff, and the lack of data processing facilities. Our general reaction is that the top level personnel are competent and have excellent ideas of what should be done but lack the means to implement the administration of the taxes effectively.

TABLE 4

Relationship of regional budget and actual revenues from own sources, Government of the Southern Region of the Sudan, 1977-1980 *

Sudan LS

	Budget estimate	*Collected to May 1*	*Collections projected to July 1*	*Percent of projected to budget figure*
1977/78				
Taxes	8,727,400	5,219,866	6,263,839	72
Nontax revenue	5,601,140	973,995	1,168,794	21
Total	14,328,540	6,193,861	7,432,633	52
1978/79				
Taxes	11,412,000	5,691,293	6,829,552	60
Nontax revenue	5,026,624	1,742,952	2,091,542	42
Total	16,438,624	7,434,245	8,921,094	54
1979/80				
Taxes	14,370,700	4,438,285	5,325,942	37
Nontax revenue	6,165,368	1,888,910	2,266,692	37
Total	20,536,068	6,327,195	7,592,634	37

* *Source:* Democratic Republic of the Sudan, Southern Region, *Annual Budget Speeches* 1977/78, 1979/80, 1980/81.

TABLE 5

Percentage distribution of budgeted provincial revenues, Government of the Southern Region of the Sudan, 1979/80, 1980/81 *

Province	*Year*	*Percentage of own revenue from*				*Percentage of total expenditure covered by*	
		Business profits tax	*Import and export levies*	*Licenses*	*Fees and other*	*Own reveneues*	*Grants*
Bahr el Ghazal	1979/80	12.9	21.5	2.8	62.7	15.3	84.7
	1980/81	12.2	13.5	3.2	69.7	12.0	82.0
Jonglei	1979/80	8.8	–	1.9	89.3	4.6	95.4
	1980/81	7.7	–	3.5	88.8	4.3	95.7
Lakes	1979/80	9.5	–	2.1	87.2	5.8	94.2
	1980/81	9.5	–	1.9	88.6	5.0	95.0
Upper Nile	1979/80	19.3	–	3.8	76.9	12.4	87.6
	1980/81	20.1	–	4.0	75.9	10.1	89.9
Eastern Equatoria	1979/80	20.6	–	11.7	67.7	14.6	85.4
	1980/81	19.2	–	9.2	71.6	11.6	82.4
Western Equatoria	1979/80	13.9	4.5	4.6	77.1	7.4	92.6
	1980/81	13.9	2.3	5.6	78.3	5.1	94.9
Total	1979/80	16.3	6.2	5.6	71.8	11.0	89.0
	1980/81	15.7	3.9	5.3	75.0	8.8	91.2

* *Source:* Data in Table A-2.

G. Provincial revenue sources

Table 5 shows the percentage distribution of the revenues of the six SR provinces by source, and Table A2 the actual figure.

The provinces expected to raise, in 1980/81, approximately LS 525,000 from taxes, LS 140,700 from licenses, and LS 2,004,450 from charges[3] and other own-

3. This includes a "shadow element" of LS 750,750 of charge revenues of the Mechanical Transport Department for other governmental agencies.

sources. They receive a total of LS 19,293,000 from the SR government, most of which is provided by the Central Government.

Their major own tax source is the business profits tax. Bahr el Ghazal and Western Equatoria impose import and export taxes on farm products, thus compounding still more the emphasis on these levies. Otherwise, the provinces collect only license taxes and miscellaneous charges and fees. They thus have only a very limited degree of financial autonomy, much less even than the local governments. The provinces and the local councils have been unable in recent years to collect more than half of the budget revenues and thus their actual own-collections are much lower than the budgeted figures.[4]

H. Local government taxes

There are two types of local councils, urban and rural, and the tax sources differ somewhat.

1. Social services tax. This is by far the major local tax from a revenue standpoint, yielding 64% of local council revenue. This is a poll tax, levied on all adult males, the rate varying by council area, and even by ethnic group within a council area.

2. Gibana, the tax on the sale of agricultural products in local markets.

3. Rates, used primarily by the town councils, imposed on the value of real property.

In addition revenue is received from licenses on traders, sellers of liquor, bicycles, and health-related activities (e.g., slaughter houses). Serious questions have been raised about the effectiveness of collection of these taxes. The percentage distribution of the revenues is shown in Table 6, the detailed figures in table A-3.

TABLE 6

Relative distribution of expected revenues by source, local councils, Government of the Southern Region of the Sudan, 1980/81 *

Percentage of total revenues from	*Township local councils*	*Rural local councils*	*Total*
Taxes	52	53	53
Licenses	13	4	5
Fees, rents	31	15	17
Province	4	28	25
Total	100	100	100
Percentage of tax revenues from			
Social services tax (Poll)	17	70	64
Gibana (Sale of produce)	20	16	16
Rates	27	9	11
Other	36	5	9
Total	100	100	100

* *Source:* Data in Table A-3.

In addition the local councils receive substantial grant funds, about 25% of total revenues, from the Central and SR governments.

For the provinces and the local councils combined, in 1977/78-1979/80 the total revenue sources were as follows:

	Expenditures LS 000	*Own revenues LS 000*	*Percent from own sources*
1977/78	15,671	7,307	46
1978/79	17,241	7,418	43
1979/80	29,990	7,143	23

Source: Democratic Republic of the Sudan, Southern Region, People's Executive Councils, *Annual Budgets for Fiscal Year 1980/81.*

I. Overall recurrent budget picture in the Southern Region

The overall recurrent budget picture for 1980/81 including SR government, provincial, and local revenues and expenditures, but excluding expenditures from donor financing, is shown in Table 7.

Thus the total recurrent government expenditure by the SR government and its subordinate units was projected to be LS 68.3 million in the 1980/81 fiscal year. Of this, LS 40 million was received in grants from the Central Government, while LS 28.5 million was to be raised locally, by taxes and charges.

The estimated per capita GNP in the SR is $150 or LS 120; thus the total GNP, assuming a population of 4 million, is LS 480,000,000. Thus the total taxes and charges constitute 6% of GNP, or taxes alone about 4%. When it is considered that the heavy Central Government customs duties and other indirect levies are also borne to some degree in the SR, the percentage collected in taxes does not appear to be extremely low by comparison with other LDCs, given the low incomes and undeveloped state of the economy.

TABLE 7

Overall recurrent budget summary, Southern Region of the Sudan, 1980/81 *

Millions of Sudan LS

	Revenue, own sources	*Grants received*	*Total expenditures* [1]
Southern Region Government	21.4	40.0	61.4
Provinces	2.7	29.7	32.4
Local councils	4.4	1.3	5.7
Total	28.5	71.0	99.5
Less duplication	–	31.0	31.0
Net	28.5	40.0	68.3

* *Source:* Data in Tables 1, A-2 and A-3.

1. Including transfers to other units and to development budget.

4. The financing problems of the provinces and local governments were stressed in the *Budget Speech* of the Minister of Administration, Police and Prisons of the Southern Region for 1980/81.

J. Evaluation of the revenue system

As noted the SR government is highly dependent upon funds provided by the Central Government. In the 1980-81 fiscal year, if all budget funds were received, the grants from the Central Government would have provided 65% of the recurrent budget and 85% of the development budget. Furthermore, nearly half of the SR's tax revenues are collected for it by the Central Government. At times at least, the Central Government has been slow to remit these funds to the SR, creating a liquidity crisis. But the more serious problem is that the taxes involved are indirect taxes, with the intent that the SR's share depend on the destination of the taxed goods in the SR. But at the time of importation or sale by the factory, the ultimate destination is often now known, or even if it is, it may not be reported accurately, especially, in view of the SR's import surcharge. The same problem arises with the profits of the sugar monopoly.

For its own source, the SR government has imposed a large number of separate taxes, many of them with nominal yield, and many related to either import or export transactions. This is a consequence of the difficulties of implementing broad based taxes and the very limited potential tax base that does not involve either import or export activities. But there are several limitations:

a) Without "fiscal frontiers," that is, control points at the borders with the remainder of the country, it is difficult to ensure appropriate collections. Smuggling appears to be relatively widespread, further complicating collections on foreign imports or exports.
b) The use of a large number of separate taxes inevitably complicates application of the taxes and produces arbitrary borderlines between taxable and non-taxable goods.
c) The taxes upon exports can easily discourage domestic production for export. Such production is only nominal at present, but hopefully it will increase. The general objection to export taxes is well known.
d) The surcharge on imports and the other taxes on imports encourage firms importing into the Sudan or producing in the north for shipment to the SR to misstate destination.
e) Taxes on products of basic consumption, such as dura, tend to burden the urban poor – a feature that can be questioned on equity grounds.

Taxes on manufactured goods produced in the SR or sold subject to controls (gasoline, sugar) or on services are much more satisfactory.

K. Potential for additional tax revenue

The potential for additional tax revenue in the SR, to lessen dependence on the Central Government and to finance continuation of various agricultural development projects and other activities now financed by donor groups, is not substantial. The inherent problem is that the SR is a very undeveloped area compared to much of Tropical Africa. Semi-subsistence agriculture dominates, and commercial activity is limited. Any significant increase in tax base, unless significant oil discoveries are made, can occur only with increased production for the market and for export, including processing of agricultural products, production of beer, cigarettes, and other articles of widespread consumption, and increased importation of consumption goods. These changes, in turn, require, more than anything else, improved transportation and communication. It would appear that the primary immediate constraint on development in the SR, and thus increase in tax capacity, is the isolation and inadequate infrastructure. Improvements in these, some beyond the control of the SR government, are the most urgently needed steps toward economic development and greater revenues.

Meanwhile, it should be possible to simplify the tax structure, reducing the number of separate taxes and lessening the heavy reliance on taxes related to imports and exports. At the same time, further strengthening of tax administration is urgently needed – as is well recognized by the SR government.

IV. THE NEW REGIONAL GOVERNMENTS

The basic philosophy of the government of the Sudan for the last decade has been to move toward greater decentralization of government, given the size and diversity of the country. After creating the SR government, the Central Government took the next major step in 1980, when it created five new regional governments and gave Khartoum special provincial status. As of late 1981, the new regional governments are functioning, but with their tax systems not yet fully developed. The Regional Government Act, which created the regions, contains a general statement that the new regions have power to levy direct and indirect taxes, but then prohibits taxes on imports and exports, interregional trade, and capital profits and "commercial dealings." The regions were specifically authorized to impose those taxes now levied by the provinces and the local governments. Thus the taxing powers are more restrictive than those of the SR.

The existing taxes of the new Regional Governments

The existing taxes of the Regions, inherited from the provinces and local governments, are as follows:

1. Primarily in urban areas: two levies on land and buildings, a general rate and a house (buildings) tax, now collected together. They are imposed upon annual rental value, as high as 30% in some areas. Assessment is in the hands of local committees of laymen rather than trained appraisers. The tax burden is typically relatively light.

2. In rural areas, there are four forms of tax, but in general no wealth or activity reached by more than one:

a. Land taxes, imposed on irrigated land, a fixed amount per feddan (approximately an acre) on smaller projects, as a percentage of the gross receipts from the crop, often 12%, on the larger. In the Gezira, in lieu of taxes the Gezira Board, which buys all cotton, pays 2% of its net profit from cotton (not from other crops) to the government.
b. The ushur, or tax on produce, called cess in much of Africa. In non-irrigated mechanized farming areas, a tax, typically 12% of the value of the produce is imposed, in lieu of property taxes. The tax is now usu-

ally collected in the markets, from the buyers. The tax primarily applies to the crops shipped in bulk for export or to other parts of the country.

c. The tax on date trees, in the North, a fixed amount per tree (of which there are about 3 million). The rate is now 8p.

d. The animal tax, applied per head of livestock, in virtually all rural council areas, but of primary importance in the Blue Nile and Darfur areas. The rate varies with the type of animal (highest on camels), and with the area. The tax is generally not administered well and reaches only a small fraction of the total number of animals.

e. Licenses: on motor vehicles and on traders.

f. Entertainment tax, on sporting events and movies.

These taxes, plus nontax revenues, which in many areas approach the taxes in total yield are expected to provide no more than 20% of the total revenues of the regions and local councils.

The remainder of the Regional revenue currently is made up of grants from the Central Government. These are not based upon a scientific formula, although obviously population plays a part. These are essentially block grants, the amount determined, after bargaining, very largely by the prospective deficit. It is generally recognized that the system is unsatisfactory, to some extent lessening the pressure to attain efficiency and to raise taxes.

V. APPROACHES TO IMPROVED FINANCING OF THE REGIONS

There are several possible approaches to the financing of the regions, including the SR.

First, emphasis can be placed upon maintaining a high degree of integration of the entire economy and effective tax administration. This approach would concentrate taxation in the hands of the Central Government, with uniform tax rates, throughout the country (apart from some local taxes). This would minimize interference with free flow of economic activity and economic distortions. But this approach, of course, does not provide financial autonomy for the Regions, keeping them dependent upon the Central Government.

At the opposite extreme, prime emphasis can be placed upon maximizing financial autonomy of the Regions, allowing them free use of major forms of taxes, with lessened use by the Central Government. But this approach would, unless the system was developed with great care, likely result in serious barriers to free flow of trade and interference with national tariff policy, because of the necessity of relying heavily upon indirect taxes. It is unlikely that the Central Government would be willing to surrender income taxes to the Regional governments, as it did to the SR.

The third alternative is, of course, a compromise: preservation of national uniformity and administration with major tax sources, but with strengthened revenue sources for the regions, and an improved system of grants, which would preserve regional expenditure autonomy, if not revenue autonomy. The experience in the SR does not offer much encouragement for the other regions so far as taxes are concerned, although levies on particular commodity sales and services offer substantially greater revenue potential than they do in the SR. Other taxes that are tolerable in the SR because of its relative isolation, such as those on exports from and imports to the region, would be intolerable in the other areas and are prohibited by the Act establishing the new Regions. But clearly some improvements and strengthening of regional and local tax administration are also possible.

Improvements in the grant system involve in part the issue of whether the Central Government payments should be of a shared revenue or grant nature. The problem with shared revenues is that many levies are not suitable for allocation on an origin basis. For example, importation and most industrial production are concentrated in a few areas, and allocation, on a destination basis, for indirect taxes is difficult administratively. The system has not worked well for the SR. Thus substantial reliance on block grants, but ones allocated on a formula basis, must be the primary basis for financing. But, above all, a workable formula, rather than political bargaining, is imperative.

VI. CONCLUSION

The Sudan provides an interesting case of deliberate decentralization of government and of revenue sources. The first major step was the creation of the SR government, granted substantial autonomy in 1972. The SR, the poorest area of the Sudan, though with great potential agricultural resources, has been able to generate a portion of its own tax revenue, but still depends heavily on the Central Government for grants, and a portion of its tax revenue is collected for it by the Central Government. It does administer the income and business profits tax in the region. In an effort to gain revenue, the SR has introduced a number of taxes, some relating to imports and exports. Some have potentially harmful effects, others provide negligible yield.

The second major step was the creation of five additional regions in 1980, with substantial governmental functions transferred to them. Thus far they have been able to implement only the taxes formerly used by the provinces and local councils: taxes on land and building rents, on the local sales of produce, on animals, and on date trees. While they have greater potential for tax revenue on local sales of various products such as gasoline and sugar and on various services than the SR, it is obvious that they must continue to rely heavily on Central Government grants. Under the circumstances of the Sudan the subordinate units of a decentralized system simply cannot, on their own, finance extensive government activities.

TABLE A-1

Budgeted tax revenues, Government of the Southern Region of the Sudan, 1980/81 *

Sudan LS

	Expected revenue Sudan LS	*% of total tax[1] revenue*
Levied by Central Government, collected by Regional Government		
Personal income tax	1,350,000	9.1
Business profits tax	280,000	1.9
Land and rental income tax	21,000	0.1
Capital gains tax	18,000	0.1
Stamp duty	125,000	0.8
Total	1,794,000	12.1
Levied by and collected by Central Government		
Revenue to Regional Government		
Excise duties	1,100,000	7.4
Consumption duties	580,000	3.9
Export duties	6,000	neg.
Surcharge on imported goods	2,300,000	15.6
Expected revenue from Revision of Presidential Decree No. 39	2,500,000	16.9
Total	6,486,000	43.9
Levied and collected by Regional Government		
General regional service and development tax		
Govt. + private employees	560,000	3.8
Devt. tax on license holders	150,000	1.0
Sugar	1,417,000	9.6
Petrol	333,000	2.3
Diesel fuel	292,000	2.0
Telegrams	17,500	0.1
Airport embarkation	36,000	0.2
Hotel bills	90,000	0.6
Dates	100,000	0.7
Mechanized farms	317,000	2.1
Cigarettes	300,000	2.0
Imported vehicles	20,000	0.1
Imported misc. appliances	15,000	0.1
Imported liquor	100,000	0.7
Imported coffee	840,000	5.7
Imported tea	200,000	1.4
Processed crocodile skins-exp.	150,000	1.0
Exported fish	15,000	0.1
Exported salt	5,000	neg.
Exported soap	15,000	0.1
Exported edible oil	2,000	neg.
Exported ready made clothes	2,000	neg.
Exported Demuria + Dabilan	5,000	neg.
Exported utensils	1,000	neg.
Exported onions	1,000	neg.
Road tolls (Border)	100,000	0.7
Exported aspro	2,000	neg.
Bicycles + parts	5,000	neg.
Contracts	45,000	0.1
Total, regional development tax	5,135,500	34.8
Sales tax	240,000	1.6
Purchase tax-2nd hand motor vehicles	6,000	neg.
Medical insurance fee	12,000	0.1
Share, profits on sugar	1,080,000	7.3
5% tax, profits of Government corporations	20,000	0.1
Total tax revenue	14,773,500	
Miscellaneous:		
Interest	70,000	
Sale of government lands	75,000	
Other	135,200	
Total, misc.	280,200	
Department fees and charges	6,356,707	
Total revenue, own sources	21,410,407	

1. As shown in the budget, minus LS 280,200 miscellaneous.

* *Source:* Democratic Republic of the Sudan, Southern Region, ***Recurrent Budget,*** 1980/81.

TABLE A-2

Budgeted provincial recurrent revenues and expenditures, Government of the Southern Region of the Sudan, 1979/80; 1980/81 *

Sudan LS

Province	*Year*	*Est. population 000s*	*Expected revenue:* *Business profits tax*	*Export and import surcharge*	*Licenses*	*Fees, charges, other*	*Total own revenues*	*Grant revenue*	*Portion of grant revenue to local councils*	*Budgeted expenditures*
Bahr el Ghazal	1979/80	1,000	90,000	150,000	19,600	437,185	696,785	4,564,462	78,000	5,182,747
	1980/81		90,000	100,000	24,000	525,000	739,000	6,138,812	100,000	6,757,812
Jonglei	1979/80	350	12,000	–	2,600	122,000	136,600	2,951,047	60,000	3,027,647
	1980/81		12,000	–	5,500	139,000	156,500	3,671,212	100,000	3,702,712
Lakes	1979/80	750	18,000	–	3,500	147,019	168,519	2,925,053	50,000	4,144,113
	1980/81		18,000	–	3,500	167,100	188,600	3,745,000	60,000	3,847,660
Upper Nile	1979/80	700	120,000	–	23,700	478,050	621,750	5,000,714	80,000	5,542,482
	1980/81		120,000	–	23,700	453,250	596,950	5,918,126	120,000	6,375,076
Eastern Equatoria	1979/80	675	150,000	–	85,000	493,650	728,650	4,976,011	110,359	5,477,652
	1980/81		150,000	–	72,000	561,000	783,000	6,740,194	120,000	7,383,194
Western Equatoria	1979/80	300	30,000	9,700 [1]	10,000	166,900	216,600	2,932,713	50,000	3,149,313
	1980/81		30,000	5,000	12,000	169,100	216,100	4,205,068	80,000	4,316,168
Total	1979/80	3,775	420,000	159,700	144,400	1,844,804	2,568,904	23,350,000	428,359	26,523,954
	1980/81	–	420,000	105,000	140,700	2,004,450	2,670,150	30,417,512 [1]	580,000	32,382,622

1. This was the sum requested by the provinces in their budgets. The sum provided in the SR government was LS 20,7000,000.

* *Source:* Democratic Republic of the Sudan, Southern Region, ***Budgets,*** 1980/81, of the respective People's Executive Councils.

TABLE A-3

Expected revenues by source and total expenditures, local councils, Government of the Southern Region of the Sudan, 1980/81 *

Sudan LS

Province		*Social services tax*	*Gibana*	*Rates*	*Other taxes*	*Total taxes*	*Licenses*	*Fees, rents, and misc.*	*Health fees*	*Total fees and and misc.*	*Total own revenues*	*Total expendi- tures*
Bahr el	T	4,500	–	53,500	5,500	63,500	29,000	42,300	17,585	59,885	152,385	103,882
Ghazal	R	343,000	4,500	108,000	–	455,500	33,500	209,300	7,166	216,466	705,466	1,002,905
Jonglei	T	41,000	32,000	8,000	–	81,000	8,800	23,500	4,100	27,600	117,400	129,541
	R	268,000	22,400	7,030	–	297,430	26,630	147,333	3,665	150,998	475,058	499,154
Lakes	T	20,000	–	13,100	–	33,100	6,600	11,350	4,464	15,814	55,514	46,331
	R	366,995	2,210	7,858	–	377,063	10,658	168,028	7,035	175,063	562,784	621,670
Upper Nile	T	–	–	–	–	–	–	–	–	–	–	–
	R	289,926	327,000	52,000	75,300	744,226	31,304	28,180	47,026	75,206	850,736	1,496,135
Eastern	T	–	40,000	25,000	131,100	196,100	30,170	53,000	50,044	103,044	329,314	376,805
Equatoria	R	336,224	68,625	20,375	42,062	467,286	25,425	162,923	13,424	176,347	669,058	809,607
Western	T	–	–	2,500	3,500	6,000	17,000	12,450	4,760	17,210	40,210	61,284
Equatoria	R	244,000	500	44,150	12,000	300,650	41,380	62,553	15,010	77,563	419,593	435,754
Total	T	65,500	77,200	102,100	140,100	384,900	91,570	142,600	80,953	223,553	700,023	717,843
	R	1,848,145	425,235	239,413	129,362	2,642,155	168,897	778,317	93,326	871,643	3,682,695	4,994,766
Total		1,913,645	492,435	341,513	269,462	3,027,055	260,467	920,917	174,279	1,095,196	4,382,718	5,712,609

T: Township Councils.
R: Rural Councils.

* *Source:* Democratic Republic of the Sudan, Southern Region, ***People's Executive Councils, Annual Budgets,*** 1980/81.
Note: Minor errors in the original tables result in some inconsistencies in the totals but do not affect the overall pictures.

U.S.A.: Draft Model Income Tax Treaty of 16 June 1981

MODEL OF. . . . . , 1981
CONVENTION BETWEEN THE UNITED STATES OF AMERICA
AND . . . .
FOR THE AVOIDANCE OF DOUBLE TAXATION AND
THE PREVENTION OF FISCAL EVASION
WITH RESPECT TO TAXES ON INCOME AND
CAPITAL

The United States of America and . . . ., desiring to conclude a convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital, have agreed as follows:

Article 1
General scope

1. This Convention shall apply to persons who are residents of one or both of the Contracting States, except as otherwise provided in the Convention.

2. The Convention shall not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance now or hereafter accorded
a) by the laws of either Contracting State; or
b) by any other agreement between the Contracting States.

3. Notwithstanding any provision of the Convention except paragraph 4, a Contracting State may tax its residents (as determined under Article 4 (Residence)), and by reason of citizenship may tax its citizens, as if the Convention had not come into effect. For this purpose, the term "citizen" shall include a former citizen whose loss of citizenship had as one of its principal purposes the avoidance of income tax, but only for a period of 10 years following such loss.

4. The provisions of paragraph 3 shall not affect
a) the benefits conferred by a Contracting State under paragraph 2 of Article 9 (Associated Enterprises), under paragraphs 1 b) and 4 of Article 18 (Pensions, Annuities, Alimony, and Child Support), and under Articles 23 (Relief From Double Taxation), 24 (Non-discrimination), and 25 (Mutual Agreement Procedure); and
b) the benefits conferred by a Contracting State under Articles 19 (Government Service), 20 (Students and Trainees), and 27 (Diplomatic Agents and Consular Officers), upon individuals who are neither citizens of, nor have immigrant status in, that State.

Article 2
Taxes covered

1. The existing taxes to which this Convention shall apply are
a) in the United States: the Federal income taxes imposed by the Internal Revenue Code (but excluding the accumulated earnings tax, the personal holding company tax, and social security taxes), and the excise taxes imposed on insurance premiums paid to foreign insurers and with respect to private foundations. The Convention shall, however, apply to the excise taxes imposed on insurance premiums paid to foreign insurers only to the extent that the risks covered by such premiums are not reinsured with a person not entitled to the benefits of this or any other convention which applies to these taxes;
b) in . . . . :
. . . .
. . . .

2. The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes which have been made in their respective taxation laws and of any official published material concerning the application of the Convention, including explanations, regulations, or judicial decisions.

Article 3
General definitions

1. For the purposes of this Convention, unless the context otherwise requires
a) the term "person" includes an individual, an estate, a trust, a partnership, a company, and any other body of persons;
b) the term "company" means any body corporate or any entity which is treated as a body corporate for tax purposes;
c) 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 entrerprise carried on by a resident of the other Contracting State;
d) the term "international traffic" means any transport by a ship or aircraft, except when such transport is solely between places in the other Contracting State;
e) the term "competent authority" means
(i) in the United States: the Secretary of the Treasury or his delegate; and
(ii) in . . . . :
. . . .
. . . .
f) the term "United States" means the United States of America, but does not include Puerto Rico, the Virgin Islands, Guam, or any other United States possession or territory;
g) the term . . . . means
. . . .

2. As regards the application of the Convention by a Contracting State any term not defined therein shall, unless the context otherwise requires or the competent authorities agree to a common meaning pursuant to the provisions of Article 25 (Mutual Agreement Procedure), have the meaning which it has under the laws of that State concerning the taxes to which the Convention applies.

Article 4
Residence

1. For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of this domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature, provided, however, that
a) 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 or capital situated therein; and
b) in the case of income derived or paid by a partnership, estate, or trust, this term applies only to the extent that the income derived by such partnership, estate, or trust is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners or beneficiaries.

2. Where by reason of the provisions of paragraph 1, an individual is 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 (center of vital interest);
b) if the State in which he has his center of vital interests cannot be determined, or if he does not have 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 has 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 1 a company is a resident of both Contracting States, then if it is created under the laws of a Contracting State or a political subdivision thereof, it shall be deemed to be a resident of that State.

4. Where by reason of the provisions of paragraph 1 a person other than an individual or a company is a resident of both Contracting States, the competent authorities of the Contracting States shall settle the question by mutual agreement and determine the mode of application of the Convention to such person.

Article 5
Permanent establishment

1. For the purposes of this Convention, 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) a factory;
e) a workshop; and
f) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.

3. A building site or construction or installation project, or an installation or drilling rig or ship used for the exploration or exploitation of natural resources, constitutes a permanent establishment only if it lasts more than twelve months.

4. Nothwitstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include

a) the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise;
b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display, or delivery;
c) the maintenance of a stock of goods or merchandise 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 or merchandise, or of collecting information, for the enterprise;
e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
f) the maintenance of a fixed place of business solely for any combination of the activities mentioned in subparagraphs a) to e).

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person – other than an agent of an independent status to whom paragraph 6 applies – is acting on behalf of an enterprise and has and habitually exercises in a Contracting State an authority to conclude contracts in the name of the enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

7. 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 the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

Article 6
Income from real property (immovable property)

1. Income derived by a resident of a Contracting State from real property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.

2. The term "real property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated.

3. The provisions of paragraph 1 shall apply to income derived from the direct use, letting, or use in any other form of real property.

4. The provisions of paragraphs 1 and 3 shall also apply to the income from real property of an enterprise and to income from real property used for the performance of independent personal services.

5. A resident of a Contracting State who is liable to tax in the other Contracting State on income from real property situated in the other Contracting State may elect for any taxable year to compute the tax on such income on a net basis as if such income were attributable to a permanent establishment in such other State. Any such election shall be binding for the taxable year of the election and all subsequent taxable years unless the competent authorities of the Contracting States, pursuant to a request by the taxpayer made to the competent authority of the Contracting State in which the taxpayer is a resident, agree to terminate the election.

Article 7
Business profits

1. The business profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the business profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State 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 business profits which it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions.

3. In determining the business profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole (or the part therof which includes the permanent establishment), whether incurred in the State in which the permanent establishment is situated or elsewhere.

4. No business profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

5. For the purposes of this Convention, the business profits to be attributed to the permanent establishment shall include only the profits derived from the assets or activities of the permanent establishment and shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

6. Where business profits include items of income which are dealt with separately in other Articles of the Convention, then the provisions of thos Articles shall not be affected by the provisions of this Article.

7. For the purposes of the Convention, the term "business profits" means income derived from any trade or business, including the rental of tangible personal property and the rental of or licensing of cinematographic films or films or tapes used for radio or television broadcasting.

Article 8
Shipping and air transport

1. Profits of an enterprise of a Contracting State from the operation of ships or aircraft in

international traffic shall be taxable only in that State.

2. For the purposes of this Article, profits from the operation of ships or aircraft in international traffic include profits derived from the rental of ships or aircraft if such ships or aircraft are operated in international traffic by the lessee or if such rental profits are incidental to other profits described in paragraph 1.

3. Profits of an enterprise of a Contracting State from the use, maintenance, or rental of containers (including trailers, barges, and related equipment for the transport of containers) used in international traffic shall be taxable only in that State.

4. The provisions of paragraphs 1 and 3 shall also apply to profits from participations in a pool, a joint business, or an international operating agency.

Article 9
Associated enterprises

1. Where
a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State; or
b) the same persons participate directly or indirectly in the management, control, or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which, but for those conditions would have accrued to one of the enterprises, but by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State, and taxes accordingly, profits on which an enterprise of the other Contracting State has been charged to tax in that other State, and the profits so included are profits which would have accrued to the enterprise of the first-mentioned Stated if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be paid to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

3. The provisions of paragraph 1 shall not limit any provisions of the law of either Contracting State which permit the distribution, apportionment, or allocation of income, deductions, credits, or allowances between persons, whether or nor residents of a Contracting State, owned or controlled directly or indirectly by the same interests when necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such persons.

Article 10
Dividends

1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident, and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed
a) 5% of the gross amount of the dividends of the beneficial owner is a company which owns at least 10% of the voting stock of the company paying the dividends;
b) 15% of the gross amount of the dividends in all other cases.

This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

3. The term "dividends" as used in this Article means income from shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.

4. The provisions of paragraph 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State, of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the dividends are attributable to such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.

5. A Contracting State may not impose any tax on dividends paid by a company which is not a resident of that State, except insofar as
a) the dividends are paid to a resident of that State,
b) the dividends are attributable to a permanent establishment, or a fixed base situated in that State, or
c) the dividends are paid out of profits attributable to one or more permanent establishments of such company in that State, provided that the gross income of the company attributable to such permanent establishment constiuted at least 50% of the company's gross income from all sources.

Where subparagraphs c) applies and subparagraph a) and b) do not apply, the tax shall be subject to the limitations of paragraph 2.

Article 11
Interest

1. Interest derived and beneficially owned by a resident of a Contracting State shall be taxable only in that State.

2. The term "interest" as used in this Convention means income from debt-claims of every kind, whether or not secured by mortgage, and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities, and income from bonds or debentures, including premiums or prizes attaching to such securities, bonds, or debentures. Penalty charges for late payment shall not be regarded as interest for the purposes of the Convention.

3. The provisions of paragraph 1 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State, in which the interest arises, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the interest is attributable to such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.

4. Interest shall be deemed to arise in a Contracting State when the payer is that State itself or a political subdivision, local authority, or resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

5. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of the Convention.

6. A Contracting State may not impose any tax on interest paid by a resident of the other Contracting State, except insofar as
a) the interest is paid to a resident of the first-mentioned State;
b) the interest is attributable to a permanent establishment or a fixed base situated in the first-mentioned State; or
c) the interest arises in the first-mentioned State and is not paid to a resident of the other State.

Article 12
Royalties

1. Royalties derived and beneficially owned by a resident of a Contracting State shall be taxable only in that State.

2. The term "royalties" as used in this Convention means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work (but not including cinematographic films or films or tapes used for radio or television broadcasting), any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial, or scientific experience. The term "royalties" also includes gains de-

rived from the alienation of any such right or propertry which are contingent on the productivity, use, or disposition thereof.

3. The provisions of paragraph 1 shall not apply if the beneficial owner 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 royalties are attributable to such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.

4. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right, or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of the Convention.

Article 13
Gains

1. Gains derived by a resident of a Contracting State from the alienation of real property referred to in Article 6 (Income from Real Property (Immovable Property)) and situated in the other Contracting State may be taxed in that other State.

2. Gains from the alienation of
a) shares of the stock of a company (whether or not a resident of a Contracting State) the property of which consists principally of real property situated in a Contracting State; or
b) an interest in a partnership, trust, or estate (whether or not a resident of a Contracting State) to the extent attributable to real property situated in a Contracting State

may be taxed in that State. For the purposes of this paragraph, the term "real property" includes the shares of a company referred to in subparagraph a) or an interest in a partnership, trust, or estate referred to in subparagraph b).

3. Gains from the alienation of personal property which are attributable to a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, or which are attributable to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, and gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or such a fixed base, may be taxed in that other State.

4. Gains derived by an enterprise of a Contracting State from the alienation of ships, aircraft, or containers operated in international traffic shall be taxable only in that State.

5. Gains described in Article 12 (Royalties) shall be taxable only in accordance with the provisions of Article 12.

6. Gains from the alienation of any property other than property referred to in paragraphs 1 through 5 shall be taxable only in the Contracting State of which the alienator is a resident.

Article 14
Independent personal services

Income derived by an individual who is a resident of a Contracting State from the performance of personal services in an independent capacity shall be taxable only in that State, unless such services are performed in the other Contracting State and the income is attributable to a fixed base regularly available to the individual in that other State for the purpose of performing his activities.

Article 15
Dependent personal services

1. Subject to the provisions of Articles 18 (Pensions, Annuities, Alimony, and Child Support) and 19 (Government Service), salaries, wages, and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if
a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in the taxable year concerned;
b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State; and
c) the remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.

3. Notwithstanding the preceding provisions of this Article, remuneration derived by a resident of a Contracting State in respect of an employment as a member of the regular complement of a ship or aircraft operated in international traffic may be taxed only in that State.

Article 16
Limitation on benefits

1. A person (other than an individual) which is a resident of a Contracting State shall not be entitled under this Convention to relief from taxation in the other Contracting State unless
a) more than 75% of the beneficial interest in such person is owned, directly or indirectly, by one or more individual residents of the first-mentioned Contracting State; and
b) the income of such person is not used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are residents of a State other than a Contracting State and who are not citizens of the United States.

For the purposes of subparagraph a), a company that has substantial trading in its stock on a recognized exchange in a Contracting State is presumed to be owned by individual residents of that Contracting State.

2. Paragraph 1 shall not apply if it is determined that the acquisition or maintenance of such person and the conduct of its operations did not have as a principal purpose obtaining benefits under the convention.

3. Any relief from tax provided by a Contracting State to a resident of the other Contracting State under the Convention shall be inapplicable to the extent that, under the law in force in that other State, the income to which the relief relates bears significantly lower tax than similar income arising within that other State derived by residents of that other State.

Article 17
Artistes and athletes

1. Notwithstanding the provisions of Articles 14 (Independent Personal Services) and 15 (Dependent Personal Services), income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio, or television artiste, or a musician, or as an athlete, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State, except where the amount of the gross receipts derived by such entertainer or athlete, including expenses reimbursed to him or borne on his behalf, from such activities does not exceed twenty thousand United States dollars ($ 20,000) or its equivalent in . . . . for the taxable year concerned.

2. Where income in respect of activities exercised by an entertainer or an athlete in his capacity as such accrues not to the entertainer or athlete but to another person, that income of that other person may, notwithstanding the provisions of Articles 7 (Business Profits) and 14 (Independent Personal Services), be taxed in the Contracting State in which the activities of the entertainer or athlete are axercised, unless it is established that neither the entertainer or athlete nor persons related thereto participate directly or indirectly in the profits of that other person in any manner, including the receipt of deferred remuneration, bonuses, fees, dividends, partnership distributions, or other distributions.

Article 18
Pensions, annuities, alimony, and child support

1. Subject to the provisions of Article 19 (Government Service)
a) pensions and other similar remuneration derived and beneficially owned by a resident of a Contracting State in consideration of past employment shall be taxable only in that State; and
b) social security benefits and other public pensions paid by a Contracting State to a resident of the other Contracting State or a citizen of the United States shall be taxable only in the first-mentioned State.

2. Annuities derived and beneficially owned by a resident of a Contracting State

shall be taxable only in that State. The term "annuities" as used in this paragraph means a stated sum paid periodically at stated times during a specified number of years, under an obligation to make the payments in return for adequate and full consideration (other than services rendered).

3. Alimony paid to a resident of a Contracting State shall be taxable only in that State. The term "alimony" as used in this paragraph means periodic payments made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support, which payments are taxable to the recipient under the laws of the State of which he is a resident.

4. Periodic payments for the support of a minor child made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support, paid by a resident of a Contracting State to a resident of the other Contracting State, shall be taxable only in the first-mentioned State.

Article 19
Government service

Remuneration, including a pension, paid from the public funds of a Contracting State or a political subdivision or local authority thereof to a citizen of the State in respect of services rendered in the discharge of functions of a governmental nature shall be taxable only in that State. However, the provisions of Article 14 (Independent Personal Services), Article 15 (Dependent Personal Services) or Article 17 (Artistes and Athletes), as the case may be, shall apply, and the preceding sentence shall not apply, to remuneration paid in respect of services rendered in connection with a business carried on by a Contracting State or a political subdivision or local authority thereof.

Article 20
Students and trainees

Payments received for the purpose of maintenance, education, or training by a student, apprentice, or business trainee who is or was immediately before visiting a Contracting State a resident of the other Contracting State and who is present in the first-mentioned State for the purpose of his full-time education or training shall not be taxed in that State, provided that such payments arise outside that State.

Article 21
Other income

1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.

2. The provisions of paragraph 1 shall not apply to income, other than income from real property as defined in paragraph 2 of Article 6 (Income from Real Property (Immovable Property)), if the beneficial owner of the income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the income is attributable to such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.

Article 22
Capital

1. Capital represented by real property referred to in Article 6 (Income from Real Property (Immovable Property)), owned by a resident of a Contracting State and situated in the other Contracting State, may be taxed in that other State.

2. Capital represented by personal property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, or by personal property pertaining to a fixed base available to a resident of a Contracting State for the purpose of performing independent personal services, may be taxed in that other State.

3. Capital represented by ships, aircraft, and containers owned by a resident of a Contracting State and operated in international traffic, and by personal property pertaining to the operation of such ships, aircraft, and containers shall be taxable only in that State.

4. All other elements of capital of a resident of a Contracting State shall be taxable only in that State.

Article 23
Relief from double taxation

1. In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow to a resident or citizen of the United States as a credit against the United States tax on income

a) the income tax paid to. . . . . .by or on behalf of such citizen or resident;

and

b) in the case of a United States company owning at least 10% of the voting stock of a company which is a resident of. . . . . . . .and from which the United States company receives dividends, the income tax paid to. . . . . . . .by or on behalf of the distributing company with respect to the profits out of which the dividends are paid.

For the purposes of this paragraph, the taxes referred to in paragraphs 1b) and 2 of Article 2 (Taxes Covered) shall be considered income taxes. Credits allowed solely by reason of the preceding sentence, when added to otherwise allowable credits for taxes referred to in paragraphs 1b) and 2 of Article 2, shall not in any taxable year exceed that proportion of the United States tax on income which taxable income arising in. . . . .bears to total taxable income.

2. In accordance with the provisions and subject to the limitations of the law of. . . . .(as it may be amended from time to time without amending the general principle hereof). . . . . shall allow to a resident or citizen of . . . . .as a credit against the. . . . . . . .tax on income . . . .
. . . .

3. For the purposes of allowing relief from double taxation pursuant to this Article, income shall be deemed to arise exclusively as follows

a) income derived by a resident of a Contracting State which may be taxed in the other Contracting State in accordance with this Convention (other than solely by reason of citizenship in accordance with paragraph 2 of Article 1 (General Scope)) shall be deemed to arise in that other State;

b) income derived by a resident of a Contracting State which may not be taxed in the other Contracting State in accordance with the Convention shall be deemed to arise in the first-mentioned State.

The rules of this paragraph shall not apply in determining credits against United States tax for foreign taxes other than the taxes referred to in paragraphs 1b) and 2 of Article 2 (Taxes Covered).

Article 24
Non-discrimination

1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected. This provision shall apply to persons who are not residents of one or both of the Contracting States. However, for the purposes of United States tax, a United States national who is not a resident of the United States and a . . . . national who is not a resident of the United States are not in the same circumstances.

2. For the purposes of this Convention, the term "nationals" means

a) in relation to . . . . ,
. . . .
. . . . ; and

b) in relation to the United States, United States citizens.

3. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. 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. Except where the provisions of paragraph 1 of Article 9 (Associated Enterprises), paragraph 5 of Article 11 (Interest), or paragraph 4 of Article 12 (Royalties) apply, interest, royalties, and other disbursements paid by a resident of a Contracting State to a resident of the other Contracting State shall, for the purposes of determining the taxable profits of the first-mentioned resident, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of a resident of a Contracting State to a resident of the other Contracting State shall, for the purposes of determining the taxable capital of the

first-mentioned resident, be deductible under the same conditions as if they had been contracted 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 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 2 (Taxes Covered), apply to taxes of every kind and description imposed by a Contracting State or a political subdivision or local authority thereof.

Article 25
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 Convention, 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 national.

2. The competent authority shall endeavor, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, 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 the Convention: Any agreement reached shall be implemented notwithstanding any time limits or other procedural limitations in the domestic law of the Contracting States.

3. 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. In particular the competent authorities of the Contracting States may agree

a) to the same attribution of income, deductions, credits, or allowances of an enterprise of a Contracting State to its permanent establishment situated in the other Contracting State;
b) to the same allocation of income, deductions, credits, or allowances between persons;
c) to the same characterization of particular items of income;
d) to the same application of source rules with respect to particular items of income;
e) to a common meaning of a term;
f) to increase in any specific amounts referred to in the Convention to reflect economic or monetary developments; and
g) to the application of the provisions of domestic law regarding penalties, fines, and interest in a manner consistent with the purposes 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.

Article 26
Exchange of information and administrative assistance

1. The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Article 1 (General Scope). 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 assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings 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).

3. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall obtain the information to which the request relates in the same manner and to the same extent as if the tax of the first-mentioned State were the tax of that other State and were being imposed by that other State. If specifically requested by the competent authority of a Contracting State, the competent authority of the other Contracting State shall provide information under this Article in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings), to the same extent such depositions and documents can be obtained under the laws and administrative practices of that other State with respect to its own taxes.

4. Each of the Contracting States shall endeavor to collect on behalf of the other Contracting State such amounts as may be necessary to ensure that relief granted by the Convention from taxation imposed by that other State does not enure to the beneit of persons not entitled thereto.

5. Paragraph 4 of this Article shall not impose upon either of the Contracting States the obligation to carry out administrative measures which are of a different nature from those used in the collection of its own taxes, or wich would be contrary to its sovereignty, security, or public policy.

6. For the purposes of this Article, the Convention shall apply, notwithstanding the provisions of Article 2 (Taxes Covered), to taxes of every kind imposed by a Contracting State.

Article 27
Diplomatic agents and consular officers

Nothing in this Convention shall affect the fiscal privileges of diplomatic agents or consular officers under the general rules of international law or under the provisions of special agreements.

Article 28
Entry into force

1. This Convention shall be subject to ratification in accordance with the applicable procedures of each Contracting State and instruments of ratification shall be exchanged at . . . . as soon as possible.

2. The Convention shall enter into force upon the exchange of instruments of ratification and its provisions shall have effect

a) in respect of taxes withheld at source, for amounts paid or credited on or after the first day of the second month next following the date on which the Convention enters into force;
b) in respect of other taxes, for taxable periods, beginning on or after the first day of January next following the date on which the Convention enters into force.

Article 29
Termination

1. This Convention shall remain in force until terminated by a Contracting State. Either Contracting State may terminate the Convention at any time after 5 years from the date on which the Convention enters into force, provided that at least 6 months prior notice of termination has been given through diplomatic channels. In such event, the Convention shall cease to have effect

a) in respect of taxes withheld at source, for amounts paid or credited on or after the first day of January next following the expiration of the 6 months period;
b) in respect of other taxes, for taxable periods beginning on or after the first day of January next following the expiration of the 6 months period.

DONE at . . . . in duplicate, in the English and . . . . languages, the two texts having equal authenticity, this . . . . day of . . . . 19...

For the United States of America:

For . . . .

GHANA:

The Investment Code, 1981

by Elizabeth de Brauw-Hay *

I. INTRODUCTION

Ghana has a new investment code – Act 437 of 1981 – which received assent on 11 August 1981. It had quickly been discovered that the provisions of existing investment legislation – the Investment Policy Decree of 1975 [1] – were acting as a severe deterrent to foreign investors; hence the introduction of a new investment code within such a relatively short time from the passing of the previous one.

Views of potential investors were sought at a special conference on Ghana's gold reserves held in Accra in January 1981 and were taken into account in the preparation of the new code. The government is particularly keen to encourage overseas investment in mining and gold mining in particular; gold, along with cocoa and timber, account for around 75% of Ghana's total export receipts and in recent years production of this mineral has been falling heavily, mainly due to lack of investment.

These and other reasons behind the new legislation, which repeals the Investment Policy Decree and amending legislation, are clearly set out in the preamble to the Code, viz.:

it is considered vital to attract foreign investments in Ghana and also to encourage investments in Ghana by Ghanaian entrepreneurs to contribute to an increase in fixed capital formation for the exploitation of the resources of Ghana and for an increased production and creation of wealth, employment and improvement in skills and the social conditions of the citizens of Ghana;

having regard to the experience obtained in the operation of previous laws in Ghana relating to investment it has been recognised that one of the most important steps necessary to be taken in order to achieve the foregoing is to operate a policy of liberalization and an open economy and assure to the foreign and Ghanaian investor protection of his investment and a fair return therefrom;

it is the policy of Ghana to operate a mixed economy;

it is considered necessary to redefine the areas of investment in which non-Ghanaians are encouraged to invest, to indicate the areas in which the State and Ghanaians are required to participate in enterprises in which such foreign investments are made and to set out the incentives available to investors in the various fields of investment considered to fall within the priority areas of investment;

it is deemed to be in the best interests of Ghana to promote large-scale investments aimed at the exploration, exploitation, and processing of the mineral resources of Ghana;

it is considered desirable to provide for the registration of technology transfer contracts.

II. ADMINISTRATION OF THE INVESTMENT CODE

The Code provides for certain benefits to investors. In order to qualify for these benefits a potential investor must have his investment approved by a body set up under the Code known as the Ghana Investments Centre. The functions of the Centre, as well as approving investments, include advising on the priority sectors into which investment should be attracted, liaising between investors and ministries and government departments, agencies, etc., ensuring compliance with investment laws in force, approving and registering technology transfer contracts relating to investments in Ghana, recommending legislation to encourage investment, monitoring the results of benefits granted to investors and advising on how the investment climate could be improved. [2]

III. APPLICATIONS FOR APPROVAL

Prospective investors should submit to the Centre an application containing a detailed description of the enterprise intended to be carried on. This application should indicate, inter alia, the product to be produced, a production scheme, the time scale for commencement of production, an investment and financial plan, the locality where it is proposed to carry on the industry, the effects of the investment on the environment, the anticipated volume of imports and exports, an employment training scheme for Ghanaians.

An approval decision will be taken within 3 months from receipt of the application and the applicant will be notified of the Centre's decision. [3]

IV. CRITERIA FOR APPROVAL

Potential investments will be examined in the light of to what extent they contribute to the development of the economy and an efficient use of its resources and economic potential, full and efficient use and expansion of the capacity of existing enterprises, savings on imports, an increase in exports and the strengthening of Ghana's balance of payments situation, a fair countrywide distribution of investments, a high level of employment, importation at reasonable cost and transfer of technology and technical skills to citizens of Ghana. The effect which any investment might have on the environment will also be looked at. [4]

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* Former senior associate of the International Bureau of Fiscal Documentation.

1. See 29 *Bulletin for International Fiscal Documentation* (December 1975) at 495 ff.
2. Investment Code, 1981, Art. 10.
3. Id., Art. 23.
4. Id., Art. 11.

V. RESERVED AREAS OF INVESTMENT

Only Ghanaians may participate in a variety of types of enterprise and in other a certain percentage of the capital of the enterprise must be owned by Ghanaians (see Appendix). In the case of mineral enterprises and enterprises engaged in the production of mineral oil or natural gas, the State will participate in accordance with the terms agreed between the Centre and the foreign investor. [5]

The Code also lays down which areas of investment will be regarded as priority areas. Broadly these are agriculture, mining (including boring for water), manufacturing, export-oriented industries, tourism, the construction and building industries and non-metropolitan industies. [6]

VI. SPECIAL PROVISIONS RELATING TO MINERALS AND OIL [7]

In cases where the State owns part of the capital of a mineral enterprise or an enterprise engaged in the production of mineral oil, an investor wishing to dispose of any part of the capital of such enterprise must first offer it for sale to the State.

Furthermore, all gold, diamonds and uranium produced in Ghana must be sold to the State.

VII. BENEFITS AVAILABLE UNDER THE CODE [8]

Benefits available under the Code fall into 2 categories – general benefits and special benefits.

A. General benefits

General benefits will be available to all enterprises approved under the Code and comprise the following:
- exemption for the first 5 years from payment of customs duties on machinery, equipment and accessories imported exclusively for the establishment of an approved enterprise;
- exemption for the 3 years after the establishment of an approved enterprise from customs duties on spare parts and other imports (other than raw materials) imported specially and exclusively for the enterprise;
- guaranteed manufacturing and establishment licence;
- exemption from selective employment tax [9] for the first 5 years;
- guaranteed personal remittance quota for expatriate personnel and the exemption of such personnel from taxes on the transfer of external currency out of Ghana.

B. Special benefits

Special benefits are also laid down in the Code for the priority areas of investment mentioned above, viz.:

1. Benefits available to agricultural enterprises

(a) Complete exemption from company income tax for the first 5 years; no dividends may be declared or paid, however, until after this benefit has terminated.

(b) Foreign companies investing blocked funds of repatriable status held in Ghana in an approved agricultural enterprise will be entitled:
- to a special import licence for machinery and equipment essential to the enterprise;
- to transfer 35 pesewas for every cedi invested (1 cedi = 100 pesewas) out of blocked funds;
- to transfer out of blocked funds 50 pesewas for every cedi of profit which could have been repatriated but which is reinvested:
- where the gestation period of an investment is more than one year, permission will be given to transfer for each year out of blocked funds 15 pesewas per cedi invested. This also applies to an additional investment made for the expansion of the enterprise. The rate of transfer will be 20 pesewas per cedi in respect of cattle rearing, oil palm, rubber, citrus, and cashew nut plantations.

The term "blocked funds of repatriable status" is defined as meaning accumulated dividends or profits or pre-1972 import credits or proceeds of foreign-owned capital sold to Ghanaians held by the Bank of Ghana awaiting transfer as well as any other certified funds.

The Investments Centre may also grant the following benefits:
- exemption from company income tax and customs duties for up to 10 years for the case of livestock and tree crops with a gestation period over 4 years;
- exemption of management staff from income tax with respect to furnished accommodation on the farm site;
- guaranteed management control for foreign investors in the case of agricultural enterprises in which there is foreign participation for such period as the Centre may determine.

2. Benefits available to the mining industry

(a) All mining enterprises will be entitled to:
- exemption from company income tax for as long as the company has not recovered the whole of its initial development expenditure; the same restriction as to declaring dividends as above operates here;
- guaranteed management control as above for the foreign investor so long as the whole initial development expenditure has not been recovered.

(b) Enterprises engaged in mineral exploitation and exploration may also benefit from the following:
- exemption from turnover tax;
- royalty on gold produced to be based on millhead grade of ore mined on a sliding scale between 2 and 6% of gross value of minerals won;
- company income tax not to exceed 45%;
- exemption of management staff from income tax with respect to furnished accommodation on mine camp.

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5. Id., Arts. 12 and 13 and First and Second Schedules.
6. Id., Third Schedule, Part 1.
7. Id., Art. 13.
8. Id., Third Schedule, Part. 2.
9. See *African Tax Systems* (Bureau of International Fiscal Documentation, Amsterdam), Section B, Ghana, I.1.2.5.

3. Benefits available to manufacturing industries

(a) All manufacturing industries will be entitled to exemption from company income tax for up to 5 years; the restriction as to declaring dividends during this period operates here, too.

(b) In areas outside Accra and Tema the following benefits may be granted on the expiry of the general benefits available:

- reduction of 25% in the company income tax payable;
- remission of 25% for customs duties on machinery, equipment and spare parts imported specificially and exclusively for the enterprise.

4. Benefits available to export-oriented enterprises

Export-oriented enterprises may be granted:

(a) exemption from company income tax for such period as the Centre may determine. The restriction on declaring dividends operates here, too;

(b) a special duty drawback of 25% on raw materials imported and used exclusively for export orders and on which customs duties have been paid;

(c) holding a certain percentage of sales proceeds in a foreign exchange account to meet repayment of initial suppliers.

5. Benefits available to tourist enterprises

Tourist enterprises may be granted:

(a) exemption from company income tax for a period not exceeding 5 years; the restriction on the declaring of dividends operates here, too;

(b) exemption from customs duties on items not immediately available in Ghana required for the establishment, construction and efficient operation of the enterprise;

(c) capital allowances at rates additional to the rates provided under the Income Tax Decree, 1975 as determined by the Centre.

6. Benefits available to construction and building enterprises

Benefits available to approved enterprises operating in the construction and building sector are as follows:

(a) exemption from company income tax for a period not exceeding 5 years. The restriction relating to declaring of dividends also operates here. It should, however, be noted that this benefit does not apply to specific construction and building contracts;

(b) exemption of management staff from income tax on furnished accommodation on the construction site.

7. Benefits available to enterprises operating in non-metropolitan areas

Approved enterprises in this category will be eligible for the following benefits:

(a) exemption from company income tax for a period not exceeding 5 years; the restriction regarding declaring of dividends operates, too;

(b) a reduction of 30% in company income tax payable and a remission of 30% of customs duties on machinery, equipment and spare parts imported specifically and exclusively for enterprises situated within the area of authority of a District Council responsible for any Regional capital. In the case of enterprises situated outside the authority of such District Councils the percentage is 40.

VIII. OTHER TAX-RELATED INCENTIVES AVAILABLE

The Code also provides for capital allowances being granted in respect of buildings, plant, machinery, structures, roads, furniture and fittings and fixtures used for the purposes of an approved enterprise at rates additional to those provided under the Income Tax Decree, 1975. [10]

A deduction for capital expenditure incurred in respect of scientific research for the purpose of the development or advancement of an approved enterprise is also available under the Code. [11] Such expenditure may be deducted from income over a 4-period beginning with the year in which the expenditure is incurred, at the rate of 25% per year.

IX. NON-TAX-RELATED INCENTIVES [12]

Of great importance to foreign investors is the guarantee that there will be no restrictions on the remittance of capital to the country of origin in the event of the sale or liquidation of an enterprise. The transfer of profits to the country of origin of an investment is also guaranteed after payment of taxes and maintenance and replacement of assets. Likewise, there will be no restrictions on the transfer of loan repayments or licence fees.

A guarantee is also given that there will be no restrictions on the entry into Ghana of foreign management and technical personnel required for an approved enterprise.

X. PROTECTION OF INVESTMENTS [13]

Central to the new Code is the guarantee that no approved enterprise may be expropriated by the government. Neither can an investor be compelled to cede his interest in the capital of an approved enterprise to a third party.

A guarantee is also given that benefits granted to an approved enterprise may not subsequently be altered to the disadvantage of the investor.

Fair, adequate and, not least, prompt compensation is, however, provided for in the exceptional cases where an enterprise is taken over or its capital ceded to a third party in the public interest.

XI. SETTLEMENT OF DISPUTES [14]

Where disputes arise between a foreign investor and the Ghanaian government over an approved investment it is provided that the government will *take all necessary steps to ensure amicable settlement of the dispute.*

10. Investment Code, Art. 19.
11. Id., Art. 20.
12. Id., Art. 16.
13. Id., Art. 14.
14. Id., Art. 17.

Should, however, it prove impossible to achieve an amicable settlement, then resort may be had to the conciliation or arbitration procedure laid down in investment protection agreements between Ghana and the country of the investor or in the International Convention for the Settlement of Investment Disputes or in accordance with any other international machinery for the settlement of investment disputes agreed to by the parties involved.

Appendix

ENTERPRISES WHOLLY RESERVED FOR GHANAIANS

Part A – Commercial enterprises

1. Any enterprise concerned with retail or wholesale trade, unless such business is carried on by or within a department store or a supermarket which has an employed capital of not less than ₵ 2,000,000.00.
2. The sale of anything whatsover in any market, petty trading, hawking or selling from a kiosk at any place.
3. Overseas business representation unless the enterprise has an employed capital of not less than ₵ 2,000,000.00.
4. Operation of taxi service and car hire service.
5. The sale under hire-purchase contract of motor vehicles including taxis or vehicles intended to be used in the operation of taxi service or a car hire service.
6. Produce brokerage.
7. Advertising agencies and public relations business.
8. All aspects of pool betting business and lotteries.
9. Estate agency.
10. Travel agency.
11. Lighterage services unless the enterprise has an employed capital of not less than ₵ 2,000,000.00.
12. Commercial transportation of passengers by land.

Part B – Industrial enterprises (including service industries)

1. Bakery;
2. Manufacture of foam materials;
3. Operation of beauty salons and barbers' shops;
4. Manufacture of cement blocks for sale;
5. Ordinary manufacture or tailoring or both of garments such as joromi, shorts, blouses, ladies' dresses, children's wear;
6. Textile screen hand printing (including tie and dye);
7. Tyre retreading;
8. Manufacture of suitcases, briefcases, portfolios, handbags, shopping bags, purses, wallets.

ENTERPRISES PART OF WHOSE CAPITAL IS REQUIRED TO BE OWNED BY GHANAIANS

1. Enterprises not less than 60% of whose capital must be owned by Ghanaians:
enterprises carrying on insurance business.

2. Enterprises not less than 40% of whose capital must be owned by Ghanaians:
enterprises carrying on banking business.

3. Enterprises in which Ghanaians must participate in accordance with terms agreed between the Ghanaian and foreign investor and approved by the Centre:

Commercial enterprises

(i) Department stores and supermarkets being enterprises exempted administratively or by executive instrument from the provisions of section 11 of the Ghanaian Business (Promotion) Act, 1970 (Act 334) or exempted under section 38 of this Code from the minimum requirements of capital prescribed or the minimum Ghanaian ownership of its capital required by this Code;
(ii) Distribution and servicing of motor vehicles and tractors, and spare parts thereof or other similar objects;
(iii) Distribution agencies for machines and technical equipment;
(iv) Operation of industrial laundry and dry cleaning;
(v) Shipping;
(vi) Distribution of petroleum products and lubricants;
(vii) Commercial transportation of goods including the operation of tankers;
(viii) Casinos;
(ix) Clearing and forwarding agencies;
(x) Operation of cold stores and ice making;
(xi) Any enterprise engaged in retail or wholesale trade where the business is carried on within a department store or a supermarket the employed capital of which enterprise is not less than ₵ 2,000,000.00;
(xii) Overseas business representation where the employed capital of the enterprise is not less than ₵ 2,000,000.00;
(xiii) Lighterage services where the employed capital of the enterprise is not less than ₵ 2,000,000.00.

Industrial enterprises (including service industries)

(i) Laundry and dry cleaning;
(ii) Manufacture of charcoal;
(iii) Manufacture of furniture (including knock-down furniture for export);
(iv) Terrazzo work;
(v) Manufacture of confectionery;
(vi) Slaughtering of animals for human consumption and storage, processing and distribution of meat;
(vii) Operation of cinemas;
(viii) Motor workshops;
(ix) Manufacture of pharmaceuticals, cosmetics and perfumery;
(x) Sawmilling;
(xi) Manufacture of insecticides, pesticides and fungicides;
(xii) Assembly of motor vehicles and cycles;
(xiii) Manufacture of plastic, metal and paper containers;
(xiv) Manufacture of paints, varnishes or other similar products;
(xv) Manufacture of packaging materials;
(xvi) Manufacture of wire, nails, washers, bolts, nuts, rivets and other similar articles;
(xvii) Printing of books and stationery (including publishing);
(xviii) Manufacture of mosquito coil;
(xix) Manufacture of metal products;
(xx) Paper conversion;
(xxi) Assembly of household electrical equipment and appliances;
(xxii) Manufacture of jewellery and related articles;
(xxiii) Manufacture of candles;
(xxiv) Fish processing;
(xxv) Manufacture of footwear;
(xxvi) Blending and bottling of alcoholic drinks;
(xxvii) Manufacture of plastic products;
(xxviii) Estate development (including building contracting work);
(xxix) Manufacture of ball-point pens, lead pencils and coloured pencils;
(xxx) Manufacture of glass, mirrors and optical equipment;
(xxxi) Manufacture of gramophone records;
(xxxii) Manufacture of chalk and writing ink;
(xxxiii) Manufacture of biscuits;
(xxxiv) Ceramics;
(xxxv) Any enterprise which is engaged in the production of the following:
 (a) Sugar, salt, soap, detergents;
 (b) Fertilizers, petroleum products, lubricants;
 (c) Matchets, hoes and all agricultural implements;
 (d) Animal feed, milk and baby food;
 (e) Textiles (by all forms of processes other than textiles screen hand printing tie and dye);
 (f) Matches, cement, rubber and products and flour;
(xxxvi) Any enterprise engaged in the brewing of beer;
(xxxvii) Any enterprise engaged in the production or preparation of tobacco or the manufacture of tobacco products;
(xxxviii) Any timber enterprise.

Pakistan's Budget for 1981-1982:

Fiscal Measures for Economic Development*

by Ahmad Khan **

The balanced economic development of a country requires the pursuit of coherent, consistent and coordinated economic policies. The policy planning itself should define the overall strategy and long term goals in unambiguous terms, especially in the historical, economic and social contexts. The policy plan also requires a constant quantitative analysis of the impact of various monetary and fiscal measures to ensure whether the desired goals have been achieved or not, so that, in the light of such analyses, necessary changes in the strategy can be made. Nevertheless, less developed countries like Pakistan, consistently faced with a resource constraint on the one hand and the desire to have an economic breakthrough on the other, find it quite difficult to work out a coordinated economic policy appropriately supplemented by necessary economic inputs. Consequently, despite the need for realization of a balanced economic growth, consistent with the hopes and aspirations of its people, the desired results of the fiscal measures adopted over a period of time may not come true.

Pakistan has historically attempted to formulate appropriate monetary and fiscal measures with a view to achieving balanced economic growth by broadening its industrial base, diverting resources to priority areas in the economy, increasing agricultural production, maximising exports, maintaining price stability, redistributing income, and improving its balance of payments. The fiscal measures employed include both direct and indirect taxes. They were further supplemented by non-tax measures such as providing the necessary infrastructure, skilled manpower, and monetary policies aimed at maintaining stable prices. In order to supplement domestic resources, liberal incentives in the form of tax concessions and investment guarantees were offered to attract foreign capital, goods and technology.

Although the present study does not intend to encompass a quantitative analysis of the impact of various fiscal and non-fiscal measures taken in the past, it might be appropriate to throw some light on the economic scenario of the country. It appears that, in spite of a satisfactory rate of growth in GDP during the past few years, "Pakistan is still in the throes of some acute problems such as low level of investment, widening trade dificit, a sick industrial sector, high rate of inflation and rising debt servicing burden". The only redeeming features in the scenario are "self-sufficiency in food production, improvement in output of other crops, a satisfactory increase in exports both in value and absolute terms, a rise in the level of home remittances, and a change in the outlook of the donor countries affecting the level of foreign economic assistance in the year to come". There is, however, a need to reinforce such gains with sound economic policies and decisive economic gains in all sectors of the economy.

The budgetary measures adopted during the current year reflect the government's desire to push the economic process ahead by providing sufficient incentives to both the industrial and agricultural sectors. The Finance Minister in his budget speech unfolded the economic policy package which the government will pursue in years to come. The fiscal measures adopted through this budget emphasize making the taxation system responsive to growth in the national economy, stricter financial management, controlling inflation, encouraging private sector investment, and improving public sector efficiency. The short term goals include raising of productivity and efficiency in agriculture and industry. The policy to restore private investment and public sector efficiency is backed by a reduction of the Annual Development Program for the industrial sector from 16 to 10 percent, and a clear policy advice to public sector enterprises to generate funds out of their own savings.

Apart from the philosophical consideration cited above, the fiscal measures adopted through the 1981-82 budget especially aim at providing incentives for private individual savings, increasing the surplus in the corporate sector for reinvestment in existing industries, encouraging investment in new industrial units, exploration for natural resources, increasing export of carpets and engineering products, developing agriculture, and construction of residential houses. Necessary changes have also been made in the tax laws to rationalize and streamline the procedures, remove fiscal anomalies and plug the loopholes.

In precise terms, the fiscal measures adopted through the 1981-82 budget are discussed below:

I. ENCOURAGEMENT OF PRIVATE SAVINGS

With a view to meeting the resource gap and encouraging the common man's association with the industrial development in the country, the government has, in the past, come out with various investment schemes like the National Investment Trust, the National Defence Savings Certificates, portfolio investment schemes of the Investment Corporation of Pakistan, postal savings schemes, etc. The investments made in such schemes and the shares and debentures of the public companies registered on the stock exchange have been historically

* This paper is essentially descriptive in nature and discusses the various fiscal measures adopted in the 1982-82 budget. Although reference has been made to the inadequacy of the fiscal measures in achieving the desired economic results, no attempt has been made to quantify the impact and interaction of monetary, fiscal and other non-tax measures to boost the economy.
** Secretary International Taxes, Central Board of Revenue, Islamabad.

considered for rebate purposes while computing the tax liability of a person. In order to further induce private savings, the existing maximum monetary limit of 40,000 Rs. has been increased to 45,000 Rs. Similarly, the existing tax exemption for dividends and capital gains on disposal of shares of capital stocks of companies has been continued. The scope of investment channels has further been widened to include "Modaraba" certificates and Participation Term Certificates. Exemption from income tax in respect of income from approved debentures has been widened to include income from Participation Term Certificates. Similarly, income from newly introduced "Profit and loss sharing accounts", along with dividend income, if any, has been exempted up to the limit of 15,000 Rs. in the case of an individual.

II. INCENTIVES FOR THE INDUSTRIAL SECTOR

The Fiscal policy incentives for the industrial sector aim at broadening the industrial base, increasing output, channelling the investment to import-substituting industries and dispersing industrial units to the less-developed areas of the country. Whereas the existing tax concessions — e.g. the tax credit for installation of machinery (for balancing,[1] modernization and replacement), the tax credit to companies for investment in shares and debentures (of the Equity Participation Fund), the concessional rate of tax on intercorporate dividends, the tax holiday for industries set up in industrial estates and less-developed areas of the country and the setting off of losses of wholly owned subsidiary companies against the profits of parent companies (if the latter are registered on the stock exchange and have prepared plans for revitalizing sick subsidiaries which are approved by specified financial institutions, etc) — have been continued, the following new measures have been adopted to encourage investment in the industrial sector in general and some priority sectors in particular:

(i) In view of the high investment cost and the large cash flow needs of new enterprises, the rate of initial depreciation has been increased from 25 percent of the cost of plant and machinery.

(ii) On account of the heavy capital outlays involved in the organised exploitation of minerals, and the lack of adequate incentives for the purpose, the rich mineral endowment of the country has remained largely unexploited. Accordingly, Pakistani companies set up between July 1, 1981 and June 30, 1985, engaged in the exploration for and extraction of selected minerals, as to be notified by the government from time to time, have been extended a full tax holiday for a period of 5 years from the date of commencement of commercial production, and a tax concession of 50 percent of the normal rate for 5 years thereafter.

(iii) In order to encourage investment in oil exploration, the existing policy of recouping the entire depreciation allowed on plant and machinery at the stage of export out of Pakistan and charging it to tax at the normal rates has been revised, and it has been decided that such machinery and plant when exported out of Pakistan shall in future be charged to tax only in respect of initial depreciation.

(iv) Under the existing rules, the cost of road transport vehicles for purposes of depreciation is deemed to be no more than 100,000 Rs. This provision was primarily meant to discourage the use of big cars. However, in view of the substantial rise in the price of cars and the fact that in many businesses, vehicles other than cars are also an operational necessity, the provision has been adding undue harship. The limit for the purposes of depreciation has accordingly been relaxed as follows:
(a) for motorcars — 150,000 Rs.;
(b) for other types of transport vehicles — actual cost.

(v) With a view to reducing the tax burden on companies and creating a better climate for investment, the corporate tax rates have also been reviewed. Consequently, the corporate surcharge of 10 percent of the income tax and supertax on companies has been reduced to 5 percent.

(vi) Companies were allowed a rebate on the surcharge on retained profits provided the free reserve did not exceed 15 percent of the paid-up capital. Since banks and financial institutions have of necessity to keep their free reserve higher than this level it was seldom that they availed themselves of the rebate facility. In recognition of this genuine problem, the limit of free reserves in such cases has been raised to 300 percent of paid-up capital.

The direct tax measures have been further supplemented by concessions in the area of indirect taxes. The general rate of sales tax on domestically produced goods has been reduced from 20 to 12.5 percent. Some of the items such as sanitary ware, washing machines, radio sets, TV sets, and other electrical applicances, etc. which were chargeable at higher rates varying between 25 and 30 percent would consequently be taxable at the standard rate of 12.5 percent. Other items such as paper and paper products, artificial leather and rexine, motor vehicle tubes, automobile parts, calcium carbide and asbestos waste which were previously liable to a tax at rates lower than 12.5 percent will continue to be levied at lower rates. On the customs side, in order to provide encouragement ot the leather goods industry, the import duty of 85 percent otherwise chargeable on wet blue goat and sheep leather has been withdrawn. Similarly, the duty on dies and moulds has been reduced from 40 to 20 percent and the sales tax leviable at 10 percent has been withdrawn to encourage the manufacture of machinery and consumer durables. Single filament bulbs for use in miners' safety lamps have also been exempted from customs duties. As a measure of protection to domestic industry, import duties have been enhanced on some goods such as natural yeast, acetic acid, carbon black, sulfur black, white and colored cement, plastic moulding compound and resins, manmade fibres, sanitary ware, kitchen ware, tiles, etc.

1. *Editor's note:* The term "balancing" (of machinery) means installation of additional machines in an industrial unit for the purpose of achieving optimum efficiency of the various interrelated components of that unit.

Similar concessions have been offered in the area of excise duties. These include:

(a) exemption from excise duty and sales tax to locally manufactured tyres and tubes for use in motorcycles, scooters and motor rickshaws;
(b) replacing the present 15 percent ad valorem rate of duty on woolen fabrics, other than carpets, rugs, blankets and shawls, by 13 percent of the retail price.

III. CONCESSIONS TO AGRICULTURE

The agricultural sector is of predominant importance to Pakistan and all possible efforts are being made to increase agricultural production. With this end in view, tax incentives, as well as other measures, are being widely used to achieve the desired objectives. The 1981-82 budget continues the existing exemption to agricultural income, and also income from poultry farming, dairy farming, cattle and sheep breeding, and fish catching. Similarly, the income from domestic manufacture of farm implements and machinery and income from renting of agricultural machinery or from providing pest control services continues up to June 1983. No additional concession on the direct taxes side has been granted through the current budget. However, in the area of indirect taxes, further incentives have been offered to encourage mechanization of agriculture, i.e.:

(a) Imported tractors imported in CKD condition for local assembly which were previously liable to an import duty of 10 percent, subsequently refunded after assembly, have been totally exempted from customs duties.
(b) Spare parts for tractors, previously charged to import duty ranging from 10 to 115 percent, have been made liable to a concessionary duty of 10 percent provided these are imported by authorised assemblers and do not exceed 20 percent of the value of imported tractors.
(c) Bulldozers, angle-dozers and levellers, previously charged to import duty and sales tax at 40 and 10 percent respectively, have been exempted from sales tax and the import duty reduced from 40 to 20 percent.

In addition to the fiscal measures referred to above, certain non-tax measures such as partial withdrawal of subsidy on wheat and increased support price of agriculture products, increased capital investment in the fertilizer industry with a fixed low price for the fertilizer (through Government subsidy) are expected to show positive results in the years to come.

IV. EXPORT PROMOTION MEASURES

Pakistan is essentially a primary goods exporting country. In recent years, the emphasis has, however, shifted towards export of finished goods, technical know-how and services, etc. With a view to encouraging exports, liberal concessions in the form of either a total tax exemption or a reduction of tax rates have been offered in the past. During recent years, it was felt that there was yet the need to further supplement the existing incentive programs to boost the export of certain items and services. Consequently, the following further tax concessions have been given through the current year's budget:

(i) The export of carpets and engineering goods is facing tough competition in the ineternational market. Similarly, the export of leather goods has been effected by the recession and depreciation of the currencies of major European countries which constitute the main export market. To protect the position of these important exchange earners in the export market, in computing the taxable income of domestic companies engaged in the export of carpets and engineering goods, an income tax concession in the form of allowing the deduction of expenditure in connection with advertisement abroad and supply of free samples shall be allowed at $1^1/3$ times the amount of actual expenditure Simultaneously, a compensatory rebate of 12.5 percent on the export of carpets and leather goods will also be allowed.
(ii) A tax concession in the form of exemption of income of Pakistan companies rendering technical services abroad to foreign enterprises has been available since 1977 if the money is repatriated to Pakistan. This concession was only partially available to non-company taxpayers. In order to bring the company and non-company taxpayers rendering technical services abroad at par, income derived by non-company taxpayers has also been exempted. This concession is also available to shared income of persons who are partners of registered firms.

V. INCENTIVES TO ATTRACT FOREIGN INVESTMENT

Whereas all possible efforts are being made to utilize domestic resources, including capital and technology, to develop Pakistan's industrial base, the need for import of foreign capital and sophisticated technology is being met through very liberal incentive programs. Tax concessions to industries in priority areas of the economy or geographical areas are equally available to foreign investors. The exemption of income of expatriate technicians engaged in industrial projects for a specified period of time and of interest on foreign loans (whether from foreign governments and their financial institutions or from private lenders) has long been in vogue.

In order to attract sophisticated foreign technology, the percentage of deductible expenditure incurred abroad (while computing the income of a foreign enterprise rendering technical services in Pakistan) has been raised from nil to 10 percent of the gross amount of such fees. The entire expenditure incurred in Pakistan, nevertheless, remains a deductible expense. Appropriate measures are also being taken to streamline the deduction of head office expenses incurred by multinational corporations on behalf of their Pakistan subsidiaries and branches. Draft Income-tax Rules, in this behalf, have been framed and circulated for public opinion.

Realising the necessity of providing a definite set of rules for the computation of income of foreign enterprises engaged in transnational business transactions and to supplement the tax incentives otherwise available under the domestic statutes, Pakistan has endeavoured to broaden its tax treaty net. Whereas conventions for the avoidance of double taxation and prevention of fiscal evasion with respect to taxes on income with most of the developed countries had been concluded by 1970, a number of similar conventions with countries like Canada, Malta, Libya, Romania, the Netherlands, Belgium, Italy, Bangladesh, Thailand, the Philippines, Malaysia, etc. have been concluded during the past few years. These conventions provide for concessional tax rates on dividends, interest, royalties, etc. It is expected that these treaties will serve as a favourable vehicle for the flow of capital, goods and technology from abroad.

An important area for foreign investment has been or is exploration and drilling for oil in Pakistan. Keeping in view the huge capital outlays in this area (and in order to reduce its oil import bill), Pakistan has entered into a number of petroleum concession agreements with foreign enterprises from Western Europe and North America. The existing tax concessions in the form of depletion allowances, reduced rate of tax, deduction of expenditure on drilling of dry holes and its carry forward to the subsequent years (where it can not be adjusted in the relevant year) have been continued.

To sum up, it can be safely stated that the fiscal measures adopted through the Budget for 1981-82 are oriented towards accelerating the place of economic development through the participation of both the public and private sectors, and to reach a stage of self-sufficiency in industrial and agricultural products.

Pakistan:

SUMMARY OF NEW TAX CONCESSIONS IN BUDGET 1981-1982

by Abdul Waheed *

The new tax measures are summarised as follows:

Tax relief has been provided to non-salaried persons falling in low income brackets:

where the total income –

(i) exceeds 12,000 but not 15,000 Rs., the amount of tax payable by an assessee shall be reduced by a sum equal to 20% of the tax payable;

(ii) exceeds 15,000 but not 25,000 Rs., the amount of tax payable shall be reduced by a sum equal to 15% of the tax payable; and

(iii) exceeds 25,000 Rs., the amount of income tax payable shall be reduced by a sum of 315 Rs.

Tax monetary limit of investment for the purposes of tax rebate has been raised from 40,000 to 45,000 Rs.

The rate of surcharge on companies has been reduced from 10 to 5%.

Exemption from tax has been granted to new residential houses constructed between 1 July 1981 and 30 June 1983 and having an annual value op to 18,000 Rs.

The rate of initial depreciation on plant and machinery of a new industrial enterprise has been raised from 25 to 40%.

In case of assets used in the exploration and extraction of petroleum, when exported out of the country, only initial depreciation shall be recaptured and charged to tax.

Pakistani companies engaged in the exploration of selected minerals have been given a tax holiday for 5 years; on the expiry of the 5 years, tax on such income shall be charged at 50% of the normal rate for the next 5 years.

Domestic companies exporting carpets and engineering goods shall be allowed expenditure on account of publicity and free sampling abroad at 1⅓ times the actual expenditure.

Exemption of income derived from rendering of technical services abroad to a foreign enterprise has been extended to non-company taxpayers.

Profits paid or credited to profit and loss sharing accounts shall be allowed as business expense to the banks.

Income tax rebate shall be allowed on investments made in purchase of Modaraba Certificates.

Investment in Participation Term Certificates shall be eligible for purposes of investment allowance, subject to the monetary and holding period limit.

Income derived from Modaraba has been exempted singly or in aggregate with other dividend income up to 15,000 Rs.

Income from PLS accounts along with dividend income, if any, shall be exempt up to 15,000 Rs.

Income from Participation Term Certificates shall be exempted along with debenture income up to 5,000 Rs.

Return on advance tax payments has been raised from 4 to 6%.

Income of a non-professional writer has been exempted up to 25,000 Rs.

A professional sportsman has been allowed exemption in respect of income from one benefit match.

In case of private limited companies with paid-up capital of 3,000,000 Rs. or more, audit by chartered accountants or cost management accountants has been made compulsory.

The Central Board of Revenue, with prior approval of the Federal Government, has been empowered to disclose any particulars of a taxpayer to the public.

The self-assessment scheme has been extended to all taxpayers filing returns for assessment year 1981-1982.

* Member (Income Tax and Joint Secretary) Central Board of Revenue, Islamabad.

PAKISTAN:

Budget 1981-82

Extract from the Budget Speech pronounced on 26 June 1981 by Mr. Ghulam Ishaq Khan, Finance Minister.

A detailed discussion of Pakistan's tax system appears in the International Bureau of Fiscal Documentation's publication: TAXES AND INVESTMENT IN ASIA AND THE PACIFIC

I. PRELIMINARY REMARKS

86. *Additional tax measures.* – Before coming to the tax proposals, I would like to briefly mention the considerations which have guided them. Although the demands on resources arising from the pressing needs of development, defence, administration, social and other services are enormous, the increase in expenditure of the government has been kept well within the rate of growth of GNP at current prices and, as I have just mentioned, it has been cut further. Even so, as tax receipts do not rise at the rate of GNP, additional resource mobilisation effort including the levy of new taxes becomes inevitable. This is a phenomenon that we have witnessed year after year and stems from the poor elasticity of taxes with respect to the tax base – be it the response of income taxes to incomes, import duties to imports or excise duties to industrial output. Furthermore, numerous exemptions and deductions make for a narrow tax base and a complex tax structure, which by facilitating evasion results in gross horizontal inequities as well as loss of revenue specific taxes lose their real value with inflation.

Poor elasticity of taxes

87. The Government has been concerned with this deficiency and has embarked upon a process of reform with a view to obviating in course of time the need for additional tax levies each year. The most encouraging reponse has been obtained in income tax where a combination of a self-assessment scheme under the new income tax law with tighter, selective enforcement has led to an extraordinary increase in revenue collections and the number of assessees.

88. *Indirect tax structures.* – A similar need exists to reform the indirect tax structures in order to make it more simple, control evasion and reduce areas of discretion and to enable the system to serve the needs of efficient resource allocations. One of the major deficiencies in the system is the heavy taxes, on raw materials which tend to be levied for revenue reasons because taxes on capital goods and consumer goods have a direct and visible impact which is generally resisted. Indeed, if taxes on raw materials are high and prevent development of uses by industries then the whole nation suffers.

89. *Tax reform.* – The flaws in the taxation structure, accumulated over many decades, cannot be removed overnight. But I hope that the measures that I will announce will mark a further significant step in the direction of tax reform. If these measures succeed in achieving the objectives in mind, the base would have been laid for a stable taxation system which will not only serve the needs of revenues but would also generate confidence by eliminating the annual uncertainty about taxation policies.

II. INCOME TAX

90. *Returns under self-assessment scheme.* – This brings me to the tax measures for the coming year. I am glad to say that the self-assessment scheme has now completed two years of its operation. During 1980-81, the campaign to educate the taxpayer about the full implications of the Scheme was stepped up and it has brought about encouraging results. Over 400,000 returns were received from the existing taxpayers as against 370,000 odd received during the preceding year. The number of taxpayers declaring increase in income over the preceding year by 10% or more was 52,718 as against 42,853 during 1979-80. This year 22,128 returns showed an increase in income of more than 20% over that of the last year. About 95% of the returns filed this year were accepted as was the case last year and the rest were subjected to detailed scrutiny.

91. *New taxpayers.* – During 1980-81, the efforts to locate new taxpayers continued unabated and over 200,000 new taxpayers were brought on to the tax register. The total number of taxpayers after deleting dead cases now stands at 844,645 which is more than double the number of taxpayers on income tax record only three years back.

92. *Collection of income-tax.* – The collection of income tax has also more than doubled in two years' time. Collections during 1980-81 are expected to exceed Rs. 670 crores as against Rs. 526 crores during 1979-80 and Rs. 334 crores during 1978-79. As a consequence the contribution of income tax to the federal revenues has increased to 19% in 1980-81 as against 17% in 1979-80 and 14.6% in 1978-79. the significant increase in collections without any increase in the tax rates bears eloquent testimony to the taxpayer's positive response of self-assessment, as well as to the commendable efforts made by the tax collectors to maximize tax revenues.

Success of self-assessment scheme

93. *Simplification of laws, forms and returns.* – Taxpayer's convenience is a matter of paramount concern to the Government. It is our constant endeavour to simplify the relevant laws, and forms and returns. The Income Tax Rules have been revised and published in a draft form for eliciting public opinion. We hope to finalise these rules in the light of the comments and reactions received by August, 1981. A new set of simplified income tax returns has also been prepared for use by different classes of taxpayers from the assessment year 1981-82. For the facility of non-English knowing taxpayers returns will be made available in Urdo also.

94. *Scope of self-assessment scheme.* – Coming to specific budget measures, it has been decided to extend the scope of the self-assessment scheme and to liberalize it further along the following lines:

(i) The scheme presently covers only such taxpayers who fulfil certain prescribed conditions. In view of the positive response from the tax paying public if has been decided to treat all returns for the assessment year 1981-82 showing taxable income as self assessment returns.

(ii) For the assessment year 1980-81, new taxpayers could show in their returns unexplained capital upto Rs. 50,000 provided the income on such capital was declared at not less than 50%. For the assessment year 1981-82, new taxpayers will be allowed to show unexplained capital upto Rs. 100,000 provided they declare an income of 50% on the first Rs. 50,000 and 40% on the balance.

(iii) For the assessment year 1980-81, immunity was given to such persons who declared income higher by 20% or more as compared with the highest assessed income in any of the three preceding years. This concession will continue to be available. However, those assessees who enjoyed immunity for the assessment year 1980-81 by declaring higher income are being given a further incentive. Such assessees will be entitled to immunity if their declared income exceeds the average (instead of the highest) assessed income of the three preceding years by 20% or more.

(iv) Under the present provisions, all self-assessment returns are first processed by accepting the declared income. Subsequently the cases selected for detailed scrutiny are re-opened. As this practice caused inconvenience to the tax payers, it has been decided that only one assessment shall be framed in all cases, whether for accepting them under self assessment or subjecting them to detailed scrutiny.

95. It is hoped that taxpayers will take full advantage of these concessions and declare their true and correct incomes in order to avail of the immunity.

96. *Personal tax rates.* – Personal tax rates have also been reviewed. It is felt that relief on the lines already available to the salaried class is called for in respect of non-salaried assessees falling in lower income brackets. It has, therefore, been decided to provide the following relief to this class of taxpayers:

(i) where the total income is upto Rs. 15,000 the income tax liability before rebate for investment will be reduced by 20%;

(ii) where the total income exceeds Rs. 15,000 but does not exceed Rs. 25,000, the income tax liability before rebate for investment will be reduced by 15%; and

(iii) where the total income exceeds Rs. 25,000 the extent of tax relief will be the same as available to persons having income of Rs. 25,000.

Reduction of rates

97. *Corporate tax rates.* – The corporate tax rates have also been reviewed. Corporate surcharge is presently 10% of the income tax and super tax on Companies. In order to reduce the burden of this tax on companies with a view to creating a better climate for investment, it has been decided to reduce it to 5%.

98. *Rebate of surcharge admissible to companies.* – At present rebate on surcharge is admissible to companies on retained profits provided the free reserves do not exceed 150% of the paid up capital. Since banks and financial institutions have of necessity to keep free reserves higher than this level, it is seldom that they avail of the rebate facility. In recognition of this genuine problem, it has been decided to raise the limit of free reserves in such cases to 300% of paid up capital.

99. *Rebate on investments.* – In order to promote savings, rebate is given on investments made by taxpayers in certain types of securities and savings schemes. The present monetary ceiling for such investments is Rs. 40,000. This limit is being raised to Rs. 45,000. The other conditions will remain unchanged.

100. *Tax treatment of certain financial instruments.* – In pursuance of Government's objective to Islamise the economy, certain financial instruments were introduced and other measures taken during the course of the year. The Income Tax Law is being amended to provide for the tax treatment of these instruments and measures on the following lines:

(i) Investment made by the first holder of a Modarba certificate issued by a specific value Modarba will not be entitled to Income tax rebate subject to the statutory limit of investment.
(ii) Income tax rebate on investment in open end Modarba will be allowed to the holder of such certificate subject to the monetary and holding period limits already provided in the law.
(iii) Income tax rebate on investment in Participation Terms Certificate (other than such Certificate acquired by purchase or otherwise from previous holder thereof) will be allowed subject to the monetary and holding period limits already provided in the law.

Islamisation of the economy

(iv) Dividend income derived from Modarba will be exempted singly or in aggregate with dividend income from NIT, ICP, PLS Account and listed companies upto Rs. 15,000.
(v) Income from Participation Term Certificates will be exempted singly or in aggregate with income from approved debentures upto Rs. 5,000.
(vi) Profits distributed among profit and loss sharing account holders shall be allowed as business expense while computing profits of banks for tax purposes.
(vii) Income from profit and loss accounts, alongwith dividend income, if any, will be exempted upto the limit of Rs. 15,000 in the case of an individual.

101. *Tax concessions in industrial sector.* – To encourage investment in industrial sector in general and some priority sectors in particular, the following tax concessions are being given:
(i) At present initial depreciation is admissible on new plant and machinery at the rate of 25%. In view of the high initial investment cosdt and the larger cash flow needs of new enterprises, it has been decided to increase the rate of initial depreciation to 40%.

Investment incentives

(ii) Because of the heavy capital outlays involved in the organised exploitation of minerals, and the lack of adequate incentives for the purpose, the rich mineral endowment of the country has remained largely unexploited. It has, therefore, been decided that Pakistani companies set up between 1-7-1981 and 30-6-1985 and engaged in the exploration and extraction of selected minerals as notified by the government from time to time shall enjoy full tax holiday for the first 5 years from the date of commencement of commercial production, and a tax concession of 50% of the normal rate for the 5 years thereafter.
(iii) Oil exploration is one of our priority areas. In order to encourage investment in this sector, it has been decided that the machinery used in oil exploration when exported out of Pakistan shall be charged to tax only in respect of initial depreciation instead of full depreciation as is the case at present.
(iv) Under the existing rules, the cost of road transport vehicles for purposes of depreciation is deemed to be not more than Rs. 100,000. This provision was primarily meant to discourage the use of big cars. However, in view of the substantial rise in the price of cars and the fact that in many a business, vehicles other than cars are also an operational necessity, the provision is acting unduly harshly. It has, accordingly, been decided to relax the limit for purposes of depreciation as under:
  (a) for motor cars the new limit will be Rs. 150,000 and
  (b) for other types of transport vehicles, the actual cost.

102. *Exemption in housing sector.* – At present houses constructed between 1st July, 1974 and 30 June 1983 enjoy tax exemption for a period of five years as under:
(a) where annual value does not exceed Rs. 12,000 – Full exemption.
(b) where annual value exceeds Rs. 12,000 – Exemption limited to Rs. 6,000.

103. In order to further encourage investment in housing sector, it has been decided that income from houses completed between 1st July, 1981 and 30th June, 1983 and having an annual value of not more than Rs. 18,000 (in the case of Islamabad Rs. 24,000) shall be exempted for 5 years. Where annual value exceeds these limits the exemption shall be restricted to Rs. 9,000 only.

104. *Concession on export of goods and technical services.* – At present a number of tax concessions are available on exports of goods and technical services from Pakistan. In the interest of exports, the following further tax concessions are being given:

Export incentives

(i) Export of carpets and engineering goods is facing tough competition from other countries. To create markets for these exports there is need for sale promotion. It has, therefore, been decided that for working out taxable income of domestic companies engaged in export of carpets and engineering goods and such other goods as are notified by the Government from time to time, expenditure in connection with advertisement abroad and on supply of freee samples shall be allowed @ 1⅓ times the amount of actual expenditure;
(ii) At present income of Pakistani Companies rendering technical services abroad to foreign enterprises is exempt from tax, if the money is repatriated to Pakistan. This concession is only partially available to non-company taxpayers. In order to bring the company and non-company taxpayers rendering technical services abroad at par, it has been decided to exempt such income derived by non-company assessees also and on case, such tax payers are firms, the share income will be exempt in the hands of partners as well.

105. *Limit of return paid by Government raised on advance tax deposited by taxpayers.* – Currently, return @ 4% is paid by Government on advance tax deposited by the taxpayers. This rate is low. It has, therefore, been decided to raise it to 6% which will bring it at par with return on treasury bills.

106. *Exemption of income of professional sportsman.* – Presently, income of a professional sportsman from the exercise of his profession including income from a benefit match is taxable. It has been decided that income of a professional sportsman from one benefit match shall be exempted.

107. *Exemption limit raised in respect of artistic and literary work.* – In order to promote literary and artistic work by non-professional writers, poets or artists, it has been decided that the exemption limit on income from this source be raised from Rs. 15,000 to Rs. 25,000.

108. *Date for filing return of income.* – Now I come to some rationalisation measures:
(i) The last date for filing of income tax returns in case of non-company tax payers whose income year ends on any day between 1st January and 30th of June is 1st of November. This date is being brought forward to 1st of October.
(ii) There is no requirement of law at present for the private companies to have their accounts audited by qualified auditors. In order to ensure that accounts of bigger private companies are properly maintained and audited it has been decided that private companies with a paid up capital of Rs. 3,000,000 or more should get their accounts audited by Chartered or Cost and Management Accountants.

Residency

109. *Resident in Pakistan.* – At present a person becomes a resident in Pakistan if his stay in Pakistan during any year exceeds 60 days and during the four preceding years exceeds 365 days. By virtue of acquiring resident status the world income of such person becomes taxable in Pakistan. It has been observed that the condition of 60 days stay in Pakistan creates hardship for Pakistanis working abroad. While, on leave in this country for a period of more than 60 days they have to face taxation on world income basis. To obviate this hardship, the condition of stay of 60 days is being changed to 90 days.

110. *Minimisation of leakage of revenue.* – To minimize the chances for leakage of revenue, the following changes are being made in the area of withholding tax at various stages:
(i) In respect of assessees liable to pay advance tax, the tax rate at import stage is being reduced from 2% to 1.5%. Such taxpayers shall pay tax at this rate on all imports and shall be entitled to adjust the payment at import stage against their advance tax liability.
(ii) Tax @ 3% of the auction price of goods auctioned by or on behalf of the Government, Local authorities, Public companies, Foreign associations, Contractors or Consultants or Consortium shall be collected by the auctioning authorities.
(iii) At present fees paid to professionals are subjected to withholding tax if total payments in the year exceed Rs. 50,000. This limit is high and is causing leakage of revenue. It is, therefore, being lowered to Rs. 10,000 in any financial year.

111. *Disclosure of particulars of income of taxpayers.* – The law prohibits disclosure of particulars of income of a taxpayer by the tax autorities. It has been observed that this provision gives undue protection to unscrupulous taxpayers whose particulars if made known to public may lead to detection of sources of income not shown to the Department. It has, accordingly, been decided to withdraw this protection and to empower Central Board of Revenue to disclose, with the prior approval of the Government, particulars of any assessee in respect of his income, assets, liabilities etc. to the general public.

112. *Notifications issued in 1980-81 incorporated in formal law.* – During 1980-81, a number of notifications were issued under Section 167 of the Income Tax Ordinance, 1979 in order to tide over difficulties experienced in the course of administering the Law. These notifications are now being incorporated in the formal law.

113. *Prospective enforcement of tax proposals.* – In the last year's budget, the principle of prospective enforcement of tax proposals being convenient to the taxpayers, was adopted. The same pattern has been generally followed this year also. Accordingly amendments relating to tax relief for small income groups, exemption of income from profit and loss sharing accounts, exemption of income from benefit matches and income of non-professional writers will be effective from the assessment year 1981-82. The rest of the amendments relating to relief measures will be effective from the assessment year 1982-83.

114. *Economic activities.* – Before coming to the field of indirect taxation I would like to state as had hinted earlier that we are in the process of restructuring the system in order to make it more responsive to increase in the level of economic activities so that the need for frequent changes in the tax rates is minimised. We intend to pursue this goal more vigorously during 1981-82 and hope to bring about substantial reform during the next couple of years. In this connection a major exercise was undertaken last year to bring the Pakistan Customs Tariff Clas-

sification in line with the latest International Customs Nomenclature for Classification of goods. While doing so, a uniform classification for the purposes of customs duty and Import Trade Control was developed which, on becoming operative from the next financial year will go a long way in minimising discretion and assessment disputes.

III. CUSTOM DUTIES

115. *Range of duties.* – As was the case with the classification, the rate structure which is another important component of the total system also needed to be simplified. Starting with 11 rates in 1967-68, the number of ad valorem rates has proliferated to 42, which provide numerous opportunities for misdeclaration and malpractices. There are a number of rates involving fractional calculations like 12½%, 47½%, 72½%, 102½% and 197½%. Whatever rationale these rates might have had at the relevant time, it is not valid any more. There are other rates against which either no duty is being collected or which make insignificant contribution to the revenue. Again there are a number of composite rates which do not serve the purpose or the philosophy of their ad valorem or specific levies. It has, therefore, been decided to convert the existing composite rates into specific rates and to reduce the number of ad valorem rates from 42 to 16 only. Staying within the existing range of duties from 10% to 350%, these sixteen new slabs are 10%, 20%, 30%, 40%, 50%, 60%, 70%, 85%, 100%, 120%, 150%, 160%, 175%, 200%, 250% and 350%.

116. *Headings in the Tariff.* – Out of 1100 headings in the Tariff, some 950 headings already carry one or the other of these sixteen rates and they remain unaffected by the change. Adjustment is required to be made only in the remaining 150 headings. It has been decided to adjust the duty on these headings in the next lower or higher slab. The general principle followed in this regard is that the duty on essential items has been adjusted by and large in the lower slab and on less essential and luxury items in the next higher slab.

Improvements of the system

117. *Duty in lower slabs.* – Items on which duty has been adjusted in lower slabs include coke and semi-coke, coaltar, petroleum products like liquid paraffin, white oil, greases and brake fluid, worked mica, glassware for laboratory use, cutting blades for machine, motor parts, motor cycles, cars upto 1,000 cc and optical elements.

118. Among items on which duty has been adjusted in the next higher slab, some items of general interest are woven fabric of silk and plywood where duty will now be chargeable @ 250% instead of 235%, and 200% instead of 195% respectively. Likewise, duties in case of cocoa paste and butter, tooth brushes and tooth pastes, motor cars with an engine capacity of 1000 cc to 1300 cc will now be chargeable @ 120% instead of 115%, 150% instead of 135% and 120% instead of 115% respectively.

119. *Specific rates on betel leaves, unmanufactured tobacco, matches etc.* – Of the composite rates on items of general interest which have been converted into specific rates, betel leaf, is presently chargeable to @ Rs. 50 per kg plus 10% ad valorem. It has now been converted to a single specific rate of 60 per kg. Similarly duty on unmanufactured tobacco has been converted from Rs. 40 per kg + 10% ad valorem to Rs. 50 per kg, unexposed cinematographic films, from 20 paisas per metre + 10% ad valorem to 30 paisas per metre, fish and whale oil, from 70 paisas per kg + 10% ad valorem to Rs. 1.60 per kg, and on safety matches from Rs. 1.92 per 1440 matches + 10% ad valorem to Rs. 288 per 1440 matches.

120. *Improvement in Pakistan customs tariff.* – In addition to rationalization of rate structure, an effort has also been made to improve the Pakistan Customs Tariff from another angle. It has been observed that identical items with minor variation become chargeable to different duties. Such a situation gives birth to assessment disputes and malpractices. A number of such items have been identified and they have been subjected to a uniform rate of duty to minimize discretion and malpractices. These changes are:

(i) Manganese dioxide with slight change in description, is chargeable under three different tariff headings and attract rates of duty and sales tax ranging from 25% duty and nil sales tax to 40% duty plus 10% sales tax. It has, therefore, been decided to charge manganese dioxide to a uniform rate of duty @ 40% plus 10% sales tax.

(ii) Cigarette paper is classifiable under three different tariff headings attracting duty rates ranging from 40% to 50%. It has been decided to charge all kinds of cigarette paper to a uniform rate of duty @ 50%.

(iii) Duty on imported man-made yarns varies from Rs. 35 to Rs. 40 per kg, the bulk of the import being in the Rs. 40 per kg category. The difference in rate of duty provides opportunities for misdeclaration and consequential loss to the Government revenues. It has been decided to subject all such types of yarn to a uniform rate of duty of Rs. 40 per kg.

(iv) Switches and fuses not exceeding 500 volts are chargeable to 85% duty; and other fuses and switches to 40% rate of duty. Importers many times declare switches and fuses of 500 volts as switches of 550 and 560 volts to evade customs duty, although there is no voltage range between 500 to 1000 in the country. In order to remove this technical flaw the description of 500 volts is being substituted by 999 volts.

(v) Clocks of C&F value upto Rs. 100 are chargeable to 100% duty whereas clocks of higher value are chargeable at the rate of 150%. At present there are very few clocks whose value is less than Rs. 100. This distinction provides scope for misdeclaration and under-invoicing. It has been decided to remove the distortion by charging all the clocks regardless of value to a uniform rate of 120%.

121. *Rationalization measures in case of products which are substitute for each other.* – Similar rationalization measures have been taken in case of products which are substitutable for each other but suffer different incidence of duty. Details of these measures are:

(i) Most of the items falling under chapter relating to plastics are chargeable to specific rate of duty. This was done to check under-invoicing in the import of these items. Acrylic sheet is another item of this chapter which is being underinvoiced. To check its under-invoicing and bring it in line with other items of this chapter it has been decided to subject it to specific rate of duty of Rs. 25 per kg instead of 120% ad valorem.

(ii) Toilet paper cut to size or shape is chargeable @ 85% duty plus 10% sales tax. On the other hand, toilet paper in rolls, imported for the manufacture of toilet paper, cut to size or shape is chargeable @ 100%. It has, therefore, been decided to enhance the duty on toilet paper cut to size or shape from 85% to 120%.

(iii) Imported chemicals which are not manufactured in the country are chargeable @ 40%. Hydrogen peroxide, which is an important raw material for textile industry, although presently not being manufactured in the country is chargeable to duty @ 85%. It has been decided to reduce its rate to 40%.

122. *Enhancement of import duties.* – As a measure of protection to domestic industry, import duties have been enhanced on the following eight items:

(i) Natural yeast will now be chargeable to 120% duty instead of 70%;

(ii) & (iii) Acetic acid and carbon black to 85% instead of 70%;

(iv) Sulphur black to 85% plus 10% sales tax, instead of 70%;

(v) Cement coloured and white to 20% and cement grey to 10% from nil rate of duty;

(vi) Plastic moulding compounds and resins to Rs. 13 per kg instead of Rs. 11 per kg;

(vii) Man-made fibres to Rs. 20 per kg instead of Rs. 15 per kg; and

(viii) Sanitary ware, kitchenware and tiles to 150% instead of 120%.

123. *Withdrawal of concession in respect of imported tickets and tags.* – Now that the facilities to print airline tickets and baggage tags have become available in the country it has been decided to withdraw the concession given to imported tickets and tags.

124. *Duty on imported wood veneer.* – Wood veneer is an intermediary product between wood log which is its raw material and plywood, the finished product. Whereas plywood is chargeable to 195% duty both wood veneer and wood log are chargeable to 100% duty. the local units which convert log into wood veneer are, therefore, at a disadvantage because high percentage wastage is involved in converting wood log into wood veneer. It has, therefore, been decided to subject the imported wood veneer to a rate of 150% which is intermediate between the rates on wood log and plywood.

125. *Mechanisation of agriculture.* – To encourage mechanisation of agriculture, the following measures have been taken:

(i) Imported tractors are chargeable to 10% rate of duty. In case of CKD import for local assembly, duty is charged at import stage and is subsequently refunded when tractor is assembled. In order to ensure that the benefit of this concession is made available to farmers immediately, it has been decided to outrightly exempt customs duty on tractors imported in CKD form.

(ii) Spare parts for tractors which are chargeable to various rates of duty ranging from 10% to 115%, will be subject to a uniform rate of 10%, in case these are imported by the authorized assemblers and do not exceed 20% of the value of imported tractors. Tractor parts imported by the commercial importers will, however, be subjected to duty at the rates applicable to general auto-parts which has been reduced from 72½% to 70%.

(iii) Bull-dozers, angle-dozers and levellers are presently chargeable to customs duty and sales tax @ 40% and 10% respectively. In view of their extensive use in agriculture, road-building as well as construction, it has been decided to withdraw sales tax altogether and to reduce the rate of customs duty from 40% to 20%.

126. *Leather goods industry.* – In the field of industry, in order to provide encouragement to leather goods industry, it has been decided to withdraw the import duty of 85% presently chargeable on the wet blue goat and sheep leather.

127. *Duty on dies and moulds.* – Dies and moulds are presently charged to 40% duty and 10% sales tax. To encourage the manufacture of machinery and consumer durables, the duty on dies and moulds is being reduced from 40% to 20%, and sales tax is being entirely withdrawn.

128. *Exemption of single filament bulb.* – Miner's safety lamps and the two-filament bulbs used therein are already exempt from customs duty. Now that single filament bulbs are also being imported for use in the miner's safety lamps, it has been decided to extend the exemption to these bulbs also.

129. *Containers.* – Containers are increasingly being used for the transportation of trade goods. The equipment for handling the containers in the port area such as fork-lift, cranes, tractor tug masters, trawlers etc. is presently chargeable to customs duties ranging from 40% to 85%. These are also chargeable to sales tax at the rates of 10% to 20%. In order to encourage the present trend to-

wards containerisation it has been decided to reduce the customs duty on the equipment used for handling the containers within port area to 20% whereas sales tax is being withdrawn altogether.

130. *Relief in respect of dental material, etc.* – The following further relief is being provided to the health sector:
(i) Dental materials and preparations which are at present chargeable to duty at rates ranging from 35% to 85% have been exempted from duty.
(ii) Oral diagonostic re-agents are exempt from customs duty but non-oral diagonostic re-agents are chargeable to duty at 40% ad valorem and 10% sales tax. It has been decided to exempt non oral diagonostic re-agents, imported in kit form from both customs duty and sales tax.
(iii) Presently the entire range of X-ray equipment except X-ray film processor is exempt from duty. It has now been decided to exempt the aforementioned processor also.

131. *Duty on watches.* – Considering the high value of watches these days it has been decided to provide relief on this item by reducing the duty from 85% to 60%.

132. *Export rebate on art-silk fabrics and garments.* – Export rebate on art silk fabrics and garments is presently being paid @ 42% of the f.o.b. value and on dyed and printed fabrics it is 45% of the f.o.b. value. A study undertaken revealed that the export values have been more than doubled whereas cost of inputs in terms of C & F price and duty per metre has increased by only 20%. This has obviously distorted the relationship between the f.o.b. export price and the actual duty paid on raw materials. It has, therefore, been decided to correct this distortion by refixing the rates of export rebates. Now the rebate on art silk fabrics and garments will be 32% of the f.o.b. value whereas in the case of dyed and printed fabrics it will be 35%.

133. *Hand knitted woollen carpets and leather goods.* – As stated earlier, export of hand knitted woollen carpets and leather goods has been affected by the recession and depreciation of the currencies of major European countries which constitute their main export markets. These items are important exchange earners for the country and in order to protect their position in the export market it has been decided to allow 12.5% compensatory rebate on their exports.

134. *Mining industry and export of gem stones.* – The Government believes that there is sufficient potential for development of mining industry and export of gem stones. It is accordingly proposed to allow concession of duty free import machinery for balancing and modernisation to marble industry and to the Gem stone Corporation for machinery required for cutting and polishing of gem stones.

135. *Changes in baggage rules.* – The following changes are being made in the Baggage Rules:
(i) Radio-cum-tape recorder is presently chargeable to import duty under the Baggage Rules. It has now been decided to exempt the same from levy of import duty.
(ii) Washing machines and gas appliances are presently allowed to be imported free of duty. Now that these are being manufactured within the country on a large scale, it has been decided to disallow their duty free import. However they would be chargeable to a concessionary rate of 125%.

136. *Warehoused goods in excess of specified period.* – Under the Customs law, imported goods can be warehoused without payment of duty normally for a period of one year. The importers, however, tend to delay the clearance of goods beyond one year. In order tocurb this tendency it has been decided that the rate of penal charge on the warehoused goods for the period in excess of one year be increased from 8% per annum to 2% per month.

IV. CENTRAL EXCISE DUTIES

137. *New measures in respect of central excise.* – In the field of central excise the following new measures have been taken:
(i) Raw materials imported for manufacture of tyres and tubes for use in motor cycles, scooters and motor rickshaws suffer customs duty ranging from 40% to 12%. The tyres and tubes are also chargable to central excise duty @ 10% and sales tax @ 10%. Consequently, the domestically produced tyres and tubes are at a serious dis-advantage vis-a-vis the imported tyres and tubes. It has, therefore, been decided to exempt this category of domestically produced tyres and tubes from both central excise duty and sales tax.
(ii) Knitting yarn is presently exempt from central excise duty. It is usually spun on the same spindles which are used for the manufacture of other yarns chargeable to duty @ Rs. 1 per kg. Cases come to notice where taking advantage of this position dutiable yarn has been cleared as knitting yarn to avoid payment of duty. To plug this loophole, it has been decided to withdraw the exemption on knitting yarn and make it chargeable to duty at the rate applicable to other dutiable yarns.
(iii) Woollen fabrics, other than carpets, rugs, blankets, lohis and shawls are presently chargeable to duty @ 15% ad valorem. Instances of valuation disputes on the basis of over charging of consumers have been reported. In order to protect both the manufacturers as well as consumers, it has been decided to link the rate of duty with the retail price fixed by the manufacturer. However, to prevent any price rise, it has been decided to replace the present 15% ad valorem rate of duty by 13% of the retail price.
(iv) (a) Metal containers which are manufactured in a factory which is not equipped with any plant or machinery capable of being operated with the aid of power, steam or natural gas are presently exempt from duty. It has been noticed that this exemption is being misused and certain large scale manufacturers get the tin sheet printed from regular tin manufacturers and convert the same into tin containers manually. To end this misuse, it has been decided to restrict the said exemption to cottage industries only as was the original intention.
(b) Metal containers manufactured by a manufacturer of vegetable ghee and kerosene oil for packing these products exclusively are exempt from central excise duty. In case, he also manufactures metal containers for packing products other than vegetable ghee and kerosene oil, he becomes dis-entitled to exemption even on metal containers manufactured for vegetable ghee and kerosene oil as well. In order to remove this anomaly, it has been decided to rationalise the exemption so as to ensure that metal containers manufactured for the packing of vegetable ghee and kerosene oil do not become dis-entitled to exemption under any circumstances.

V. SALES TAX

138. *Self clearance procedure in respect of goods manufactured or produced in Pakistan.* – It may be recalled that since 25th April, 1981, sales tax on all goods produced or manufactured within the country is being collected under the excise mode of collection. For the convenience of the manufacturers, however, the self-clearance procedure of the excise mode of collection has been applied. Consequently, no resident staff is posted to the factories and the manufacturers have complete freedom in the conduct of their day-to-day business.

139. *Collection of sales-tax.* – In order to make the excise mode of collection more effective, it has been decided to amend the Sales Tax Act so as to:
(i) redefine the term "sale price" in order to make it applicable to all taxable goods, whether excisable or not;
(ii) merge the two provisos to Section 3 of the Sales Tax Act (which provide for the excise mode of collection for excisable and non-excisable goods separately) into one; and
(iii) apply the provisions of the Central Excises and Salt Act, 1944 to the exclusion of the normal provisions of the Sales Tax Act. It has also been decided to make the provisions of the Customs Act, 1969 similarly applicable to the collection of sales tax on the imported goods. However, the self-clearance procedure of excise mode of collection, to which I have referred earlier, will be applied and no resident staff will be posted at the factories.

140. *Standard rate of sales tax.* – At present, the standard rate of sales tax is 20%. As in the case of customs duty, over a period of time, the rates have multiplied with the result that domestically produced goods have become chargeable to rates ranging from 5% to 30%. The multiplicity of rates has given rise to innumerable difficulties and avoidable disputes. It has, therefore, been decided to reduce the standard rate on all domestically produced goods to 12.5% and to abolish all rates above 12.5%. This will mean that items currently liable to rates of 15%, 20%, 25% and 30% will now be charged to the new standard rate of 12.5%. However, six commodities namely asbestos waste, paper and paperboard, tyres and tubes, calcium carbide, automobile parts and artificial leather and rexine will continue to be charged at the existing rates which are lower than the new standard rate of 12.5%.

141. The reduction in tax rates will bring relief to a majority of manufacturers of taxable goods, like sanitaryware, which was chargeable to 30%, tarpulines which was chargeable to 15%, and bakery products, sweet meats, sodium silicate, tents, plastic products and T.V. sets which were all liable to 20% rate and a number of other products.

142. In addition to general relief in the form of substantial reduction in the standard rate of sales tax applicable to the domestically produced goods, certain other relief and rationalization measures have also been taken:
(a) At present nuts, bolts and screws which are component parts of machinery are exempt from sales tax. Similarly, nuts, bolts and screws produced by cottage industry are also exempt. Besides, the majority of units are quite small which have to compete with cheaper imports. It has, therefore, been decided to exempt locally manufactured nuts, bolts and screws, including wood screws.
(b) The local sodium sulphide manufacturers are also facing disadvantage viz-a-viz imported product. In order to protect the local industry, sodium sulphide manufactured in the country, is being exempted.
(c) Domestically manufactured chip board and particle board of thickness of more than 7 mm, which is the substitute of timber, will be exempt from sales tax whereas other varieties of chip board and particle board will be chargeable at the new standard rate.
(d) Presently asbestos tiles, asbestos cement tiles, vinyl tiles and brick tiles are liable to sales tax @ 20% whereas glazed ceramic tiles and marble tiles are exempt. As all these commodities are close substitutes of each other, it has been decided that tiles of all description will be uniformly charged to tax at the new standard rate of 12.5%.
(e) Leather footwear is presently exempt from sales tax. Rubber footwear in which the value of rubber is at least 75% of the total value of raw material; and non-leather footwear the price of which does not exceed Rs. 25 per pair, are also exempt. Polyurethane footwear is, however, chargeable at 20%. It has been decided that footwear of whatever material

will be exempt from sales tax if the retail price does not exceed Rs. 125 per pair. All footwear the price of which exceeds Rs. 125 per pair will now be chargeable to the new standard rate of 12.5%. This measure will treat different types of footwear in a like manner and will also shift incidence of tax from low priced to high priced footwear.

143. *Sales tax on paraformaldehyde abolished.* – Sales tax on imported paraformaldehyde, a raw material for manufacturing urea formaldehyde, is being abolished.

144. *Exemption to small manufacturing units.* – Exemption from sales tax was granted to small manufacturing units functioning on cottage industry basis, provided certain prescribed conditions were fulfilled. One of the conditions relates to the amount of capital employed in business.

145. *Capital employed.* – However, "capital employed" was not properly defined. Taking advantage of this loose definition, quite a few large manufacturers split their units to avail of the exemption. To plug this loophole a similar definition of the term "capital employed" is being provided in both, the Sales Tax and the Central Excise Laws. It is proposed to define "capital employed" as to mean every type of capital including borrowed capital. It has also been provided that if a person obtains machinery and fixtures on rent the value of such assets will be included in the amount of capital employed. Investment in business premises will not be considered while computing the amount of capital. In addition to these changes, all other existing conditions relating to cottage industry will remain in force.

VI. WEALTH TAX

146. *Return of Wealth tax.* – A fairly large number of property owners have failed to comply with the statutory requirement of filing their returns under the Wealth Tax Act. We could have easily invoked the penal provisions of law but we have decided not to do so in order to afford another opportunity to the defaulters to comply with the statutory requirements. It has accordingly been decided that the property owners who file the returns for the earlier years by 1st September, 1981 and pay at least 50% of their tax liability simultaneously shall not be subjected to the penal action under the law. the returns for 1981-82 may be filed by 1st October, 1981. The last date for furnishing wealth tax returns has been changed from 15th September to 1st October to synchronise with income tax returns of non-company assessees.

147. *Wealth tax on individual having more than one property, etc.* – In the case of a firm, an association of persons or body of individuals, whether incorporated or not immovable property held for the purpose of the business of construction and sale or letting out is liable to incidence of wealth tax on the portion of its value which exceeds rupees five lakhs. Some persons have started fragmenting their total investment in units of less than rupees five lakhs to avoid payment of wealth tax. In order to check such tendencies, it is being provided that wealth tax will be payable by an individual if he owns more than one such properties and his shares in different properties exceed rupees five lakhs.

VII. GIFT TAX

148. *Rate of gift tax.* – The present gift tax rates are effective since 1963. As prices have risen over the years it has been decided to reduce gift tax rates as under:

On the first Rs.	50,000 of taxable gifts.	From 5% to 2.5%.
On the next Rs.	100,000 of taxable gifts.	From 10% to 5 %.
On the next Rs.	150,000 of taxable gifts.	From 15% to 7.5%.
On the next Rs.	500,000 of taxable gifts.	From 20% to 10 %.
On the next Rs.	1,000,000 of taxable gifts.	From 25% to 20 %.
On the balance of taxable gifts.		From 30% to 25 %.

Malaysia: British company having no permanent establishment not subject to tax on management fees

– Euromedical Industries Ltd. (EIL) *v.* Director-General of Inland Revenue –

In January 1981 the Malaysian High Court decided that EIL, a company resident in the United Kingdom, was not subject to Malaysian income tax on certain management fees because EIL did not possess a permanent establishment in Malaysia. The facts in this case were as follows. In 1973 Euromedical Industries Sdn. Bhd. (EISB) was created in Malaysia for the purpose of manufacturing catheters. EIL and EISB concluded a contract under which EISB paid EIL managerial fees for the provision of three directors and staff supplying managerial, planning, training, technical, operational, marketing and development services. The Malaysian Inland Revenue found that these management fees were subject to income tax.

EIL appealed to the High Court and it was established that:

(1) The management fees were royalties as defined in Section 2 of the Malaysian Income Tax Act, which reads (as far as is relevant):
"royalty" includes –
- (a) any sums paid as consideration for the use of, or the right to use –
  - (i) copyright, artistic or scientific works, patents, designs or models, plans, secret processes or formulae, trademarks or tapes for radio or television broadcasting or other like property or rights;
  - (ii) know-how or information concerning technical industrial, commercial or scientific knowledge, experience or skill;
- (b) income derived from the alienation of any property, know-how or information mentioned in paragraph (a) of this definition;
- (c) amounts paid in consideration of services rendered by a non-resident person or his employee in connection with the use of property or rights belonging to, or the installation or operation of any plant, machinery or other apparatus purchased from, such non-resident person; and
- (d) any other amounts paid in consideration of technical advice, assistance or services rendered in connection with technical management or administration of any scientific, industrial or commercial undertaking, venture, project or scheme.

(2) The management fees did *not* fall within the royalty definition of Article I(3) of the Malaysia–United Kingdom tax treaty of 30 March 1973 which reads (as far as is relevant):

(3) The term "royalties" as used in this Article means a repayment of any kind received as consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, any patent, trademark design or model, plan, secret formula or process or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience. The term, however, does not include any royalty or other amount paid in respect of motion picture films or of tapes for radio or television broadcasting, or of the operation of a mine, oil well, quarry or any other place of extraction of natural resources or of timber or forest produce.

(3) However, since the management fees are not covered by the royalty article they must fall under Article VI of the Treaty dealing with business income. This article provides (in part):

1. The income or profits of an enterprise of one of the Contracting States shall be taxable only in that Contracting State, unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, tax may be imposed in that other Contracting State on the income or profits of the enterprise but only so much thereof as is attributable to that permanent establishment.

...

5. Where income or profits include any items or profits which is dealt with separately in another Article of this Agreement, the provisions of that other Article shall not be affected by the provisions of this Article.

The High Court, therefore, held that EIL was not subject to Malaysian income tax with respect to the management fees it received. However, the Inland Revenue has appealed to the Federal Court.

Of course, the principles of this decision are also applicable under other tax treaties concluded by Malaysia, i.e. with Australia, Belgium, Canada, Denmark, France, German Fed. Rep., India, Japan, New Zealand, Norway, Poland, Singapore, Sri Lanka, Sweden and Switzerland. For the texts of the treaties, see *Taxes and Investment in Asia and the Pacific,* Part Treaties, under Malaysia.

BANGLADESH:

1981 INCOME TAX AMENDMENTS

by K.A. Gofran*

A detailed discussion of the Bangladesh tax system appears in the Bureau's publication TAXES AND INVESTMENT IN ASIA AND THE PACIFIC

Income tax is an annual charge levied by the Parliament at the rate fixed each year by the Finance Act on the taxpayer's total income of the previous year (accounting year immediately preceding the assessment year).

Several amendments have been made in the Income-tax Act, Sales-tax Act, Gift-tax Act, Wealth-tax Act and Urban Immovable Property Tax Act by the Finance Act, 1981.

This article deals briefly with the amendments of the Income-tax Act which are important for international investors in Bangladesh.

INCOME-TAX ACT, 1922

1. *Section 4(3)(via)*

The limit of exemption has been raised to 2,500 Tk. from 2,000 Tk. on account of any receipts of a casual and non-recurring nature other than receipts (i) from winning lotteries, (ii) capital gains, (iii) receipts arising from business, profession, vocation or occupation and (iv) receipts by way of addition to the remuneration of an employee.

2. *Section 4(3)(xvi)*

Previously, interest to the extent of 500 Tk. on any deposit in a savings account with a scheduled bank, co-operative bank or co-operative society was exempt from income tax. This provision has been widened. The exemption of interest is now up to 3,000 Tk. on any kind of deposit but such exemption is available only to an assessee who is an individual.

3. *Section 4(3)(xviii)*

The exemption available on account of interest from a scheduled bank, co-operative bank or co-operative society together with interest on securities and approved debentures will be limited to 5,000 Tk.

4. *Section 7(1)*

An assessee chargeable under the head "Salaries" used to enjoy an exemption of 3,600 Tk. if he owned and maintained at his own expense a car registered in his name and did not receive any conveyance allowance or any other benefit or perquisite in lieu of such allowance from the employer. Similarly, the exemption available was 1,800 Tk. if the conveyance was any other power driven vehicle and 1,500 Tk. if no vehicle was maintained by him. The above exemptions have been respectively raised to 4,200 Tk., 2,400 Tk. and 1,800 Tk. this year.

It may, however, be remembered that the exemption is not available if the assessee, in addition to his income chargeable under the head "Salaries", derives income from business, profession or vocation.

5. *Section 9(1)(i) and 9(1)(ii)*

One sixth of the bona fide annual value of property was until now allowed as a deduction on account of cost of repairs irrespective of whether any expenditure was incurred or not. Henceforth one fifth of such value will be allowed as a deduction from the bona fide annual value.

6. *Section 9A (6)*

Agricultural income up to 3,600 Tk. was exempt from payment of tax under sub-section (6) of section 9A. The provision of such exemption has been withdrawn.

7. *Section 10(4)(d)*

An employer used to be allowed to deduct the lesser of 50,000 Tk. or 50% of the salary, perquisites or other benefits granted to any employee. This limit has been raised to 60,000 Tk. or 50% of the salary, whichever is less.

8. *Section 10(4)(g)*

A new clause (g) has been added to sub-section (4) of section 10. This provision puts a restriction on the admissibility of expenses incurred by an assessee on account of entertainment or services rendered in cases of sales and services liable to excise duty. Such expenses will not be allowed unless supported by an excise stamp or seal.

9. *Section 14A(2BB)*

A new sub-section (2BB) has been inserted providing for a "tax holiday" for expansion of an existing industrial undertaking if such expansion constitutes an identifiable industrial unit or a similar unit for the carrying out of an identifiable industrial process subject to fulfilment of conditions as laid down in section 14A(2B).

The tax holiday will not, however, be available to an industrial undertaking which is formed by the splitting up or the reconstruction or reconstitution of any business already in existence or by the transfer to a new business of any machinery or plant used in a business carried on in Bangladesh.

10. *Section 15(3)*

Previously the limit of exemption, i.e. investment allowance, was 30% of total income or 30,000 Tk., whichever was less. This limit has now been raised to 30% of total income or 35,000 Tk., whichever is less.

11. *Section 15(3A)*

A new sub-section (3A) of section 15 has been inserted. It puts a restriction on calculation of the investment allowance under section 15(3). Subject to limitation as provided in section 15(3), the aggregate sum of exemption, other than the sums exempted for premiums paid for life insurance, deduction for deferred annuity and

* Editor, *Bangladesh Tax Decisions.*

contribution to a Government or Recognised Provident Fund, shall be up to 5,000 Tk. if the investment does not exceed 5,000 Tk. The amount of allowance available is 5,000 Tk. plus 60% of the amount exceeding 5,000 Tk. The full amount of insurance premium, deferred annuity and contribution to Provident Fund will be taken into account for the purpose of exemption subject to the overall limits.

12. *Section 15AA(1)*

By amending sub-section (i) of section 15, Unit Certificates issued by the Investment Corporation of Bangladesh have also now been made an item for which exemption under section 15AA(1) is available. In other words, purchase of such certificates will also be considered for the purpose of investment allowance.

13. *Section 18(3BB)*

Previously there was provision for deduction of tax at such rate or rates as may be prescribed by a person responsible for making any payment to another on account of supply of goods, execution of a contract or for services rendered, and by the Collector of Customs in the case of an importer or exporter. Now the scope of this provision has been widened by the inclusion of "indenting commission" in section 18(3BB) for the purpose of deduction of tax. It may be mentioned that a rule prescribing rates of deduction has so far been made in the case of supply of goods, execution of a contract or for services rendered. It is gathered that rates are being prescribed for deduction of tax in respect of import and export and indenting commission.

14. *Section 18(1)*

The liability to pay advance tax under section 18A (1) used to be attracted if the total income of an assessee as per the latest completed assessment (either normal or provisional) exceeded 20,000 Tk. This limit has now been raised to 25,000 Tk.

15. *Section 22(1)*

An individual was required to furnish along with the return or certificate, as the case may be, a statement of total assets and liabilities of himself, his wife or wives and his minor children if his/her total income exceeded 20,000 Tk. for any assessment year. This limit has been raised to 25,000 Tk.

16. *Section 23(3A)*

The limit of total income for presumptive assessment under section 23(3A) was 15,000 Tk. The limit has been raised to 20,000 Tk.

17. *Section 24(3)*

A new proviso has been added to sub-section (3) of section 24. Any amount received in cash as subsidy from the Government will henceforth be deducted in computing any loss for the purpose of set off and carry forward of loss under section 24.

18. *Section 28(1)*

An amendment has been made to sub-section (1A) of section 18 empowering the Deputy Commissioner of Taxes to impose a penalty also for understatement of the value of any immovable property in connection with sale or transfer with a view to evading tax.

19. *Section 34(2)(iv)(b)*

Sub-clause (b) of clause (iv) of the proviso to sub-section (2) of section 34 has been amended providing for a time limit to make assessment or re-assessment, as the case may be, in consequence of, or to give effect to any finding or direction in, an order under sections 31, 33, 33A, 34A, 66 or 66A or, in the case of a firm, an assessment to be made on a partner of a firm in consequence of an assessment made on the firm.

The previous legal position in this regard was that an assessment or re-assessment could be made (a) in the case of any such order made before 1 July 1975 within 4 years from that date, and (b) in any other case, within 2 years from the end of the year in which such order was made. An amendment regarding the time limit in respect of other cases has been made this year giving retrospective effect from 1 July 1980 authorising asn assessment or reassessment (a) in the case of any such order made on or after 1 July 1976 and before 1 July 1978 up to 30 June 1982, and (b) in any other case, within 2 years from the end of the year in which such order was made. The amendment does not appear to cover the cases of assessment or reassessment in consequence of such orders made during the financial years 1975-76 and 1978-79.

20. *Section 46(5A)*

A new paragraph has been added to sub-section (5A) of section 46. It provides that if any person to whom a notice under sub-section (5A) is sent fails to make payment in compliance therewith he shall be deemed to be an assessee in default for the amount specified in the notice and further proceedings may be taken against him for the recovery of the amount.

21. *The Third Schedule (Rates of income tax)*

The limit of total income liable to tax has been raised to 15,000 Tk. in the case of every individual, Hindu undivided family, unregistered firm, association of persons and every artificial juridical person (excluding a company and local authority). The number of slabs of taxable income has been reduced to 7 with lower rates of income tax compared to the previous rates. The rates now range from 10 to 60% of taxable income in the case of the above-mentioned kinds of assessees. The rate of 60% is applicable on the amount of taxable income exceeding 150,000 Tk.

A provision has been made this year to charge income tax at a concessional rate in the case of a resident and ordinarily resident assessee other than a company if he brings into Bangladesh through official channels his income accruing and arising outside Bangladesh. The rate of tax is 30% of such income or at the rate applicable to his total income including such income, whichever is more beneficial to him.

The rate of income tax is 50% of total income (excluding dividend income from a Bangladeshi company) in the case of every industrial company and 60% in the case of other companies including banks and financial institutions and local authorities. The income from dividends declared and paid by a Bangladeshi company or a body corporate in respect of the share capital issued, subscribed and paid after 14 August 1947 is liable to tax at the rate of 15% of such dividend.

The rate of income tax has been reduced to 30% from the previous rate of 60% in the case of a non-resident assessee.
Every registered firm is liable to income tax at rates ranging from 10% of total income exceeding 15,000 Tk. to 30% of total income exceeding 150,000 Tk.

U.S.A.: Return of tax treaties
(British Virgin Islands and Cyprus)

Mr. Percy, from the Committee on Foreign Relations, submitted the following

REPORT
(To accompany S. Ex. Res. 4)

The Committee on Foreign Relations, having had under consideration an original executive resolution (S. Ex. Res. 4) providing for the return to the President of pending income tax treaties with Cyprus (Ex. I, 96-2) and the British Virgin Islands (Treaty Doc. 97-6), reports favorably thereon and recommends that the Executive Resolution do pass.

Purpose

By this resolution the Senate would return to the President for renegotiation two bilateral income tax treaties, with Cyprus and the British Virgin Islands, which are pending before the Committee on Foreign Relations.

Committee action

On September 15, 1981, the Committee received the following letter concerning these tax treaties from Assistant Secretary of the Treasury for Tax Policy John E. Chapoton:

Department of the Treasury
Washington, D.C., September 15, 1981

Hon. Charles H. Percy,
Chairman, Senate Committee on Foreign Relations,
U.S. Senate, Washington, D.C.

Dear Mr. Chairman: I am writing with reference to the hearings scheduled by the Foreign Relations Committee on September 24, 1981, to consider fourteen pending tax treaties. For reasons which I will explain, I am hereby requesting that the Committee's consideration of the treaties with Denmark, Cyprus and the British Virgin Islands be delayed to give the Treasury Department time to negotiate certain modifications in those treaties.

Because of a recent amendment to Denmark's tax law, modifying the manner in which Danish corporations and their shareholders are taxed, Danish tax officials have requested that we renegotiate one provision of the pending treaty before it enters into force. We would like to accommodate Denmark's request. We intend to negotiate a Protocol to the Danish treaty. That Protocol, when signed, will be transmitted to the Senate for consideration along with the treaty which is now pending.

With respect to Cyprus and the British Virgin Islands, our desire to amend the treaties has come about as a result of our review of these treaties in preparation for hearings. Both of these jurisdictions are tax havens. The pending treaties with both were designed to prevent, or at least limit, the extent to which residents of third countries can use these treaties, in conjunction with favorable internal law provisions in those jurisdictions, to receive U.S. treaty benefits. We have concluded, on the basis of our review of these treaties, that the opportunities which potentially remain for such use are too great for us to tolerate. We intend to raise our concerns with the Governments of both jurisdictions, and seek modifications in these treaties consistent with our present policy. Although we are confident that the proposed British Virgin Islands treaty can be satisfactorily renegotiated, the existing British Virgin Islands treaty has been, and will continue to be as long as it is in force, subject to greater abuse than is likely to occur under the proposed treaty. Thus, in light of our concerns as expressed above, if satisfactory negotiations are not concluded by early 1982, the Administration intends to serve notice of termination of the existing treaty in accordance with its terms. In such event, termination would be effective January 1, 1983.

It should be noted that this procedure is not necessary with respect to Cyprus, since there is no existing treaty in force.

I hope that you will agree to delay consideration of these three treaties.

With best wishes.

Sincerely,

John E. Chapoton
Assistant Secretary (Tax Policy)

Assistant Secretary Chapoton reiterated the position of the Reagan administration with respect to these treaties at a hearing of the Committee on Foreign Relations held on September 24, 1981. On the basis of this request the Committee deferred taking any action on either of these treaties until its regular business meeting on December 8, 1981, when the Committee voted unanimously by voice vote to report out an original executive resolution returning both treaties to the President for renegotiation.

Committee comments

In view of the position of the executive branch on these treaties, as well as the serious reservation expressed by the chairman of both the House Ways and Means and Senate Finance Committee because of their potential for abuse by the residents of third countries, the Committee believes it desirable to return them to the President for renegotiation rather than to maintain them indefinitely on its calendar.

The Committee supports the objective of meaningful anti-treaty shopping provisions and therefore supports the effort to renegotiate the proposed treaties. The Committee may also support termination of the existing treaty with the British Virgin Islands if a more satisfactory agreement cannot be achieved. However, the Committee would expect to have further consultations with the executive branch prior to any decision on the termination of an existing treaty in accordance with the procedures appropriate to such a decision.

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FOR FURTHER INFORMATION PLEASE WRITE TO:

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In next issues:

Hong Kong: Tax aspects of foreign currency gains
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The fiscal structure in Jamaica
– by *H.W.T. Pepper*

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– by *Jap Kim Siong*

Tax incentives of industrialized countries for private undertakings in developing countries
– by *Eugen Jehle*

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INHALTSVERZEICHNIS

SOMMAIRE

The Fiscal Structure of Jamaica

by H.W.T. Pepper

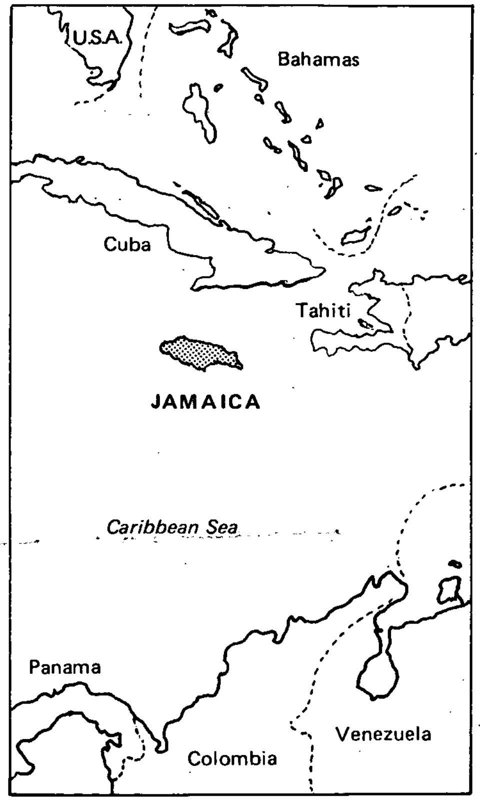
I. INTRODUCTION

Jamaica is a fairly large Caribbean island, approximately 150 miles long by 50 miles wide, at latitude 18 degrees North situated strategically between Florida and Latin America. The population is about 2,200,000.

The official, and spoken, language is English. A New Government was elected in October 1980, on a platform of encouraging free enterprise and foreign investment, for a 5-year term. The government is bi-cameral, having a House of Representatives and a Senate under the titular headship of a Governor-General.

The Jamaican dollar is linked to the U.S. dollar at a fixed rate of US$1 = J$1.778 and tourists coming to the island are permitted to pay taxi fares and hotel bills in U.S. dollars if they wish.

Of total tax revenue raised in the fiscal year 1979-80, 49% came from indirect taxes, 29% from direct taxes, and 22% from levies on bauxite and alumina of which Jamaica is a major producer. There is a wide spectrum of tax and other incentives to encourage industrial investment, tourist facilities, and exports, including, of course, the protected markets provided under the CARICOM, Lomé II, Commonwealth Preference, and other arrangements.



II. COMMUNICATIONS

Jamaica has good air links with the United States (1 hour to Florida, 3½ hours to New York) and Europe (9 hours to London), and also to other parts of the Caribbean and Central and South America. There are 6 or more flights per day to Miami and daily flights also to New York and Toronto.

There are several good harbours, Kingston – the capital – having one of the best in the world which is equipped for container ships and roll-on, roll-off ships which ply on regular service between Jamaica and the United States, and Jamaica and Europe.

There are excellent telephone, telex, and cable links with the rest of the world and there are direct dialling systems operating between Jamaica and North America.

Internally there is an air network – one can fly from Kingston to Montego Bay in 20 minutes – and also bus and rail services. Most of railway revenue comes from haulage for the bauxite companies, but passengers services are also provided and there are good roads between all the main towns and villages for bus, coach and other vehicular traffic.

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III. INTERNATIONAL LINKS

Jamaica is a member of the United Nations, the World Bank, the IMF, CARICOM (The Caribbean Common Market), ACP (the African-Caribbean-Pacific Group of Nations which has important links with the EEC through the Lomé II Agreement), and is a founder-member of the International Bauxite Association which negotiates minimum prices for alumina exports.

Jamaica is a member of the British Commonwealth of Nations, and of the OAS (Organisation of American States). Jamaica is also a beneficiary of GSP (Generalised System of Preferences) accords made by Canada and the United States with Jamaica in 1974 and 1976 respectively, and has a Bilateral Textile Agreement with the United States as well as trade agreements with Mexico and Venezuela which, inter alia, provide favourable terms on which oil may be imported.

Double taxation treaties with the United Kingdom, United States, Canada, Denmark, Federal Germany, Norway, New Zealand, and Sweden facilitate investment by those countries in Jamaica.

Law of the Sea

The decision was taken in August 1981 to site the International Seabed Authority (ISA) in Jamaica. The ISA is one of the many organisations of the United Nations and the fact that Jamaica has been thus honoured should further enhance its status as a suitable place to hold international conferences, as well as having some useful economic and touristic spin-offs.

IV. TRADE

As a member of CARICOM, Jamaica has access to the markets of its fellow members on a duty-free basis, the members being Barbados, Guyana, Jamaica, and Trinidad and the smaller countries Antigua-Barbuda, Belize, Dominica, Grenada, Montserrat, St.Kitts-Nevis, St.Lucia, and St.Vincent and the Grenadines.

Outside CARICOM, the Lomé II Convention gives duty-free access for Jamaica, as one of the 58 ACP countries, into the EEC in respect of over 99% of the items produced in Jamaica (and, of course, in the other ACP countries as well).

Jamaica also benefits from the Commonwealth Preference provisions available to members of the British Commonwealth of Nations of which Jamaica itself is a member, and from GSP (Generalised Schemes of Preferences) agreements with the United States and Canada. The latter, together with the Textile Agreement with the United States, make it possible for a U.S. firm to set up an industry in Jamaica whereby garment cut-outs can be sent to Jamaica for finishing and putting together for re-import into the United States duty-free for sale to customers there.

Jamaica enjoys quotas for traditional exports to the United Kingdom of bananas and sugar, the latter at fixed prices which are usually more favourable than the going world price.

Tourism, which counts as an "invisible export", draws customers from North America during the Northern winter months and from Europe in the summer months although in practice tourists from many countries arrive at all times of the year. Business conferences by U.S. organisations qualify for tax deductions in the United States – if held abroad – only if they take place in approved countries, e.g. Canada, Mexico, Puerto Rico, and the U.S. Virgin Islands. Jamaica's name has now been added to this select list which should help to expand both touristic and trade links between the two countries.

The flow of trade is assisted by the Jamaica Export Credit Insurance Company (JECIC), run by the (Central) Bank of Jamaica, which provides insurance for Jamaican exports. Various countries which export to Jamaica provide parallel cover for exports to Jamaica, e.g. Britain through its Export Credit Guaranteed Department (ECGD), the Netherlands through the Nederlandse Crediet Verzekering Maatschappij (NCM), and the United States through the Overseas Private Investment Corporation (OPIC).

V. INCOME TAX

Taxpayers resident in Jamaica, who are also domiciled there, are taxable on world income, on the basis of the amount arising. Tax is payable on the gross amount of the foreign income, whether it is remitted or not to Jamaica. Individuals who reside in Jamaica, but are domiciled in some other country, or being Commonwealth citizens are not ordinarily resident in Jamaica, are taxable in Jamaica on their Jamaican income; their foreign income, however, is taxed in Jamaica only to the extent that it is remitted to Jamaica.

Assessment

The income tax year runs from 1 January to 31 December, and self-employed individuals, partnerships, and corporate bodies are required to render self-assessment forms each year by 15 March, estimating the income likely to arise in the current year, and computing the relevant tax thereon. Normally the estimate is based on the previous year's income, but the taxpayer may amend his estimate at any time during the year if he finds that his current income is likely to be more or less than estimated. Tax is payable in quarterly instalments, the first on 15 March when the form is rendered, the rest on 15 June, 15 September, and 15 December.

The final accounting for tax for that year comes when the declaration of income for the year is made on 15 March in the following year. At that date a final self-assessment declaration of the actual income and tax liability for the preceding year is required and the balance of the tax is to be paid (or refunded if there was an overestimate).

If the taxpayer does not render his form, the Commissioner may make an estimated assessment – the taxpayer may object to this within 30 days. Under new provisions being introduced, the objection will not be valid unless it is accompanied by the necessary statement of income and tax. The Commissioner, in the absence of the statement, may order it to be submitted within 90 days, failing which the assessment may be confirmed. The Commissioner may extend the 90 days in appropriate cases, such extension being subject to a payment of tax on account. The taxpayer may appeal the confirmation of the assessment to the new Board of Revenue.

A. Corporate taxation

All corporate bodies, including associations (but not partnerships) are liable either to Company Profits Tax (CPT) and Additional Company Profits Tax (ACPT) or to Income Tax (IT), at the following rates:

	CPT	ACPT	Total
Agricultural companies	25 %	10 %	45 %
Other companies	35 %	10 %	45 %
	IT		
Life assurance companies	37.5%		37.5%
Estates and trusts	37.5%		37.5%
Building societies	30 %		30 %

Exemption is given from CPT and ACPT (and IT) for approved pension and superannuation funds, and for charities.

Dividends paid by companies are subject to withholding of tax at source at the rate of 37.5%, the tax deducted being accounted for by the company in the manner indicated below.

Where the shareholder receiving the dividend is a company, no further tax is payable by the recipient since the rate of tax payable by the company is 37.5% and relief of the same amount is due in respect of the 37.5% withheld by the distributing company.

Preference dividends paid by a company are deductible from profits in the same manner as debenture interest, but there is no deduction for ordinary dividends.

Dividends paid by a company out of capital are not charged to income tax on the recipient, but are subject to the 5% Transfer Tax.

The Additional Company Profits Tax is available to a company in its accounting for tax withheld from dividends paid out of its profits, as demonstrated in the following examples.

An individual taxpayer receiving dividends is chargeable on the gross amount at his marginal rate of tax, but is credited with the tax withheld at source.

Life assurance companies and *building societies,* besides being taxed at a rate lower than the ordinary corporation tax rate, benefit from the fact that tax relief is given to policy-holders and depositors in respect of premiums and deposits, respectively, which are paid to those institutions. In addition, the interest paid out by building societies on deposits left for a year or more are free of tax to the investor.

Life assurance companies, however, are also subject to a small levy on premium income excluding premiums relating to approved superannuation funds. The levy is 0.5% for Jamaican companies and 2% for others.

Banks are taxable at the ordinary corporate tax rate of 45%, but also benefit from the exemption from tax of interest paid to customers who place money on deposit for a year or more, a relief provided by the 1981-82 Budget.

Example A

Company tax on profit and dividends

	Company profit		CPT	ACPT
	$100		35	10
Total tax	45			
Profits available for distribution	55			
Gross dividend	40			
less tax withheld @ 37.5%	15			
Net cash dividend	25			
Tax to be accounted for by company		= $15		
less ACPT		10		
Net tax due		5		
Plus CPT		35		
ACPT		10		
Total tax payable by company		$50		

Tax payble by shareholder

Assume shareholder's marginal rate	= 50%	
Gross dividend $40 @ 50%	= 20	tax
Less tax withheld @ 37.5%	= 15	
Net tax payable on dividend by shareholder	$ 5	

Example B

	Company profit		CPT	ACPT
	$100		35	10
Total tax	45			
Profits available for distribution	55			
Gross dividend	25			
less tax withheld @ 37.5%	9.37			
Net cash dividend	$15.63			
Tax to be accounted for by company		= $9.37		
Covered by ACPT		10		
Net liability		Nil		
Plus CPT		35		
ACPT		10		
Total tax payable by company		$45		

Tax payble by shareholder

Assume shareholder's marginal rate	= 30%
Gross dividend $25 @ 30%	= 7.50
Less tax withheld @ 37.5%	= 9.37
Tax credit available to taxpayer for refund or offset against other tax	$1.87

Employment income is subjected to PAYE deductions at source according to the individual's code number, based on his entitlement to reliefs. To obtain a code number the individual must complete an "application for code number" form (P.1). If his domestic circumstances change during the year he may apply for a revised code number. If at the end of the year he finds he had additional tax reliefs to claim he completes a full return form and this is also necessary where he has received income not taxed by PAYE deductions.

The self-employed and those whose income is not, or not fully, subjected to PAYE are required to make by 15 March each year declarations indicating their probable income for the year, and tax thereon, as the basis for making quarterly payments of tax.

Tax reliefs for personal savings, referred to above under "shares subscription", have been extended by the 1981-82 Budget.

B. Personal income tax

Income tax in Jamaica is charged on personal income accruing in the calendar year at the following rates.

First	$ 7,000	30 %
Next	$ 3,000	40 %
Next	$ 2,000	45 %
Next	$ 2,000	50 %
Remainder	(over $14,000)	57.5%

There are no deductions from statutory income – instead reliefs are accorded in terms of tax as follows (tax credits).

Type of relief	*Relief in terms of tax*
Personal allowance	$600
Wife allowance	$140
Alimony or maintenance payments	40% of amount paid, or $160 tax if less
Wife's earned income	40% of earned income up to maximum of $320 tax
Child allowance	$10 per child
Child at university	$120 per child
Dependent relative	$40
Household helper	$4 p.w. max $208
Pensioner's allowance	$400
Special credit	$156 – allowable if income below $12,000

In addition there are various tax credits to encourage saving and investment, viz.:

Life assurance premiums (on life of taxpayer or wife)	60% of premiums paid (max. tax $360) + similar relief for an equity-linked life policy ("capital growth investment") so that maximum relief = $720
Donations	40% of eligible donations (not exceeding 1/20th of statutory income)
Mortgage interest	40% of interest paid – max. $60
Medical expenses	40% of expenses, or $40 tax if less
Shares subscription (regarding payments on 5-year contract to Building Society or Credit Union)	60% of sums paid, max. $360

C. Depreciation

1. *General*

Depreciation allowances on qualifying assets are calculated in the first year on cost and subsequently on the declining balance or written-down value of the asset, except in the case of motor vehicles. Commercial motor vehicles other than motor cars qualify for initial allowances (see below) and all types of qualifying vehicle are depreciated at the rate of 12.5% on a straight-line basis.

2. *Qualifying assets*

Industrial buildings, including factories, mills, warehouses, and buildings housing machinery and plant, but not office buildings (which, however, qualify for a 2.5% straight line depreciation allowance), qualify for straight-line allowances at rates from 2.25% to 5% according to the nature of the building. Plant and machinery generally qualify for an initial allowance of 20% and annual allowances (see below); expenditure on mines, oil wells, etc., patents and scientific research also qualifies.

3. *Investment allowances*

Investment allowances are granted at the rate of 40% of qualifying capital expenditure by sugar cane farmers and sugar manufacturers, and other farmers, on ships and on docks in respect of passenger facilities. For "basic industries" 20% is allowed which includes canning and preserving, textiles, and many other types of manufactures. These allowances are given in the first year, are not deducted in arriving at written-down value, and are not taken into account in computing balancing allowances and charges (see below).

4. *Initial allowances*

Initial allowances are granted at the rate of 20% on the cost of industrial buildings and plant and machinery. The rate for commercial vehicles is 12.5%. The allowances are in addition to the annual allowances and are deducted in arriving at the written-down value.

5. *Annual allowances*

The rates of depreciation allowance on the various types of qualifying assets vary broadly according to the estimated working life of the asset.

6. *"Multi-shift" etc. allowance*

If machinery is used on the basis of 2 or more 8-hour shifts per day, the annual allowance due on the machinery is doubled. Where a qualifying motor vehicle is used to such an extent that it will have a less than normal life, depreciation thereon may be increased.

7. *Balancing allowances and charges*

When qualifying assets are sold, scrapped, or destroyed and the disposal proceeds, including insurance and recoveries, exceed the written-down value, a balancing charge representing the excess (not exceeding the depreciation allowed) is taxed as income of the taxpayer.

Where the proceeds fall short of the written-down value the difference is deductible as a balancing allowance in computing profits.

8. *Depletion*

Depletion allowances are granted regarding the working of minerals (including oil) at the rate of 20% initial, plus an annual allowance proportionate to the rate of exhaustion of the mineral deposits (output of taxable period divided by that output plus remaining reserves), subject to a minimum deduction of 5%.

D. Relief for losses

1. *General*

Losses incurred in business activities, which if profitable would be taxable, may be carried forward for 5 years. A loss for tax purposes may be created where depreciation allowances (see above) exceed taxable profit and the same 5-year carry-forward limit applies. In the case of that part of a loss created by investment allowances, however, the carry-forward period is extended to 11 years.

2. *Hobby-farming*

In the case of hobby-farmers, with effect from 1 January 1982, losses will not be available to offset against other income, but may be carried forward to set against future profits from the farm.

E. Double taxation relief

Foreign income, taxable in Jamaica, which qualifies for double taxation relief is taxable on the gross amount before deduction of foreign tax, the relief for foreign tax being then offset against the Jamaican tax on the foreign income.

Relief is available on income derived from other countries in the British Commonwealth, and also on income from countries which have double taxation treaties with Jamaica (the United Kingdom, United States, Canada, Denmark, West Germany, Norway, and Sweden – negotiations are also in progress for such treaties with certain other countries).

Under double tax treaties relief for doubly-taxed income is given in the country of residence at the rate to which the income has been subjected in the other country, or at the rate applicable in the residence country, whichever is less.

Some types of income, however, may be exempted by one of the countries, allowing the other the sole right to tax. This may apply to the income of shipping and airline companies which are usually taxable only in the country of residence, and some types of pension may be taxed in one country only. Favourable treatment, i.e., exemption in one country or restriction of the amount of tax to be withheld in the paying country, is also generally accorded to interest, dividends, and royalties.

Double tax relief in respect of Commonwealth income is granted at the rate of tax charged in the other Commonwealth country where that rate does not exceed one half the Jamaican rate of tax on the same income. Where the Commonwealth tax rate exceeds one half the Jamaican rate, the relief is given at half the Jamaican rate.

VI. INDIRECT TAXATION

Customs duties in Jamaica are fixed at the level prescribed by CARICOM.

Imported goods may be subjected, in addition to consumption duties, to a 10% stamp duty, and there is also a retail sales tax of 10% levied on certain consumer durables such as refrigerators, television sets, and air-conditioners. Motor vehicles are subjected to much higher rates of sales tax, but substantial abatements have recently been granted in respect of vehicles used for haulage or for agricultural purposes generally.

Locally manufactured goods are subject to excise duties and/or consumption duties as well as to retail sales tax where applicable, but the manufacturers are entitled to duty-free imports of raw materials, etc.

Exports are usually free of all local indirect taxation, and a Free Zone (Export Processing Zone) has been established in Kingston for export-oriented industries which amounts to a "tax haven" since apart from freedom from indirect taxation, income tax holidays for an indefinite period are also granted. A Free Zone is also to be provided at the country's second largest port, Montego Bay.

Although indirect taxation is high there are numerous abatements and exemptions, and certain foodstuffs are actually subsidised.

VII. PROPERTY TAX

Property tax has been charged since 1974-75 on a site (capital) value or unimproved value basis on land only and on the basis of 1973 values. There is no tax on buildings, and the system provides the maximum incentive for site development.

Land being used for agriculture is taxed at 25% of the normal tax rates, and there are provisions for abatement of the tax in case of hardship. Land used for hotels is taxed at 75% of the normal tax rates.

The tax rates are:

Value	*Tax*
not exceeding $2,000	$5 (minimum)
$2,000 to $4,000	$5 + 1% of excess over $2,000
$4,000 to $10,000	$25 + 1.75% of excess over $4,000
$10,000 to $16,000	$130 + 2.5% of excess over $10,000
$16,000 to $25,000	$280 + 3.25% of excess over $16,000
$25,000 to $50,000	$572.50 + 4% of excess over $25,000
Over $50,000	$1572.50 + 4.5% of excess over $50,000

There are approximately 520,000 taxable properties and the annual yield of the tax is around $25,000,000 so that its incidence is by no means oppressive. The tax may be paid in one sum, or in two, or four instalments. In the case of some mortgagors of private property there are schemes whereby the property tax may be paid in monthly instalments along with the mortgage payments.

VIII. OTHER TAXES

A. Payroll tax

There are two types of payroll taxation, the social security or "National Insurance" levy and the National Housing Trust levy, both of which involve contributions from both employer and employee.

(a) *National insurance contributions*

Contributions are payable by employers in respect of employees at fixed rates up to a maximum of $3.75 per week. The employee also contributes, his maximum payment being $3.65 per week. The funds are used to provide old age pensions and other social security benefits. At the lower end of the contribution scale, a domestic helper contributes 10 cents per week and her employer 20 cents.

(b) *National Housing Trust (NHT)*

3% is charged on payroll, payable by the employer, and 2% of his emoluments is paid by the employee to provide funds for the National Housing Trust which builds low cost housing for sale on mortgage. Mortgages are let out at sub-economic interest rates varying from 4 to 8%. The employee is entitled to a refund of his contributions plus interest after 7 years but he continues to subscribe at the same 2% rate, so that a fund of 7 years' contributions from employees will remain in being. The 7-year refund system does not apply to the employers' contributions.

Contributions by employers to both schemes are tax-deductible. The employee receives a deduction for his NIS contribution but not for the (refundable) NHT contribution.

B. Hotel room tax

A tax ranging from US$4 to $6 per room is charged on occupancy in hotels in the main tourist season (15 December to 30 April). The tax is reduced to a range of US$2 to $4 during the rest of the year. The tax is related to the classification of the hotel which in turn is related to the level of the charges made for rooms.

C. Stamp duties

There are stamp duties on various documents ranging from a few cents on waybills and bills of lading to moderate ad valorem charges on life policies, mortgage deeds, etc. The highest rate is charged on conveyances of property, rising to approximately 2.66% on transfers over $2,000.

D. Transfer tax

On transfers of real property and leases thereof 5% of value is charged after exemption of the first $4,000 of value. Where real estate is disposed of at a price less than, or not much greater than, the acquisition price, the taxpayer may claim that the tax shall not exceed 25% of the excess of disposal price or value over acquisition price or value. If there is no excess, there is no 5% transfer tax payable.

E. "Death duty"

Transfers of property at death are exempted up to $10,000, the rate schedule being:

First	$ 10,000	exempt
Next	$ 10,000	7.5%
Next	$ 40,000	10 %
Next	$ 50,000	12.5%
Over	$110,000	15 %

IX. INCENTIVES

The incentives for manufacturing, agricultural, and tourism enterprises in Jamaica are generous, reaching their peak in the Free Zone referred to below.

Approved manufacturing enterprises may receive tax holidays of 5, 7, or 9 years according to the amount of local added value embodied in their output. Manufacturing goods for export outside the CARICOM area may rank for a 10-year tax holiday, and builders of factories for a tax holiday enterprise may qualify for a 15-year tax holiday. In all these cases there is also broad exemption from customs duties on raw materials for export industries, and from customs and other indirect taxes on imported equipment and machinery.

For new hotel enterprises the tax holiday may extend to 10 or 15 years, and resort cottages may qualify for 7 years of tax holiday. In both cases there is also initial exemption from customs duty on imports of construction materials and equipment.

For approved agricultural enterprises the tax holiday has increased by the 1981-82 Budget from a maximum of 5 to a maximum of 9 years, again in accordance with the amount of local added value embodied in the products. Another 1981-82 innovation is a provision allowing duty-free importation of trucks or lorries used in agricultural enterprises.

Motion picture producers may also obtain tax holidays on a similar basis to the above industries.

Farmers who make losses in their tax holiday period may carry them forward for a further period of 6 years after the end of the holiday. As mentioned under V. Income tax above, farmers also benefit by a lower rate (35%) of tax.

Dividends paid in the tax holiday period out of exempted profits are themselves also exempted from tax for the benefit of the shareholder.

The "Free Trade" or import duty exemption privileges available overseas to exporters of products grown, manufactured, processed, or assembled in Jamaica are quoted above under IV. Trade.

There are other favourable factors for those investing in enterprises in Jamaica, such as the provision of trading estates, factories for rent, and training grants to industries employing Jamaican labour.

There is a Free (Export Processing) Zone in Kingston and another is projected for the second largest port, Montego Bay. The main fiscal features are:

(a) indefinite tax holidays;
(b) exemption from indirect taxation on imports, and freedom from import licensing restrictions;
(c) freedom from exchange control; and
(d) no restriction on repatriation of profits.

In addition, factory and warehouse space may be rented in the Free Zone, and there is no restriction on the issue of work permits for expatriate executive and technical personnel.

Products from foreign companies operating in the Kingston Free Zone are granted preferential status in the import markets of the United States, Canada, Japan, the EEC, Switzerland, Denmark, Australia, New Zealand, and COMECON.

Export rebates in the form of a percentage reduction in the rate of corporate profits tax charged are available after the end of the tax holiday period. The rebate varies from 25% where between 10% and 21% of the profits of the enterprise are derived from exports, to 50% where the export profits are 61% or more of total profits.

Offshore companies are charged only 2.5% on their profits if certain conditions are fulfilled under the International Finance Companies (Income Tax Relief) Act 1971. The company must be at least 95% foreign-owned both as regards voting capital and loan stock, and its trading must be wholly off-shore. The company may, however, have a local office and use the services of local professionals.

Property tax is not chargeable on Government properties, so that manufacturers who rent industrial sites or factories from Government have no liability to Property tax.

JAMAICA:

BUDGET 1981-82

On 28 May 1981, the Right Hon. Mr. Edward Seaga, P.C., Prime Minister and Minister of Finance and Planning in Jamaica, introduced his Government's first Budget after its election in 1980. The Government was elected on a platform, inter alia, of encouraging foreign investment, private enterprise, and divesting a number of industries which had been nationalised by the previous Government. Extracts from the Budget Speech concerning tax changes and incentives are reproduced below. See the preceding article by H. W. T. Pepper for a general review of the fiscal system in Jamaica.

I now turn to the question of investment.

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The development of an investment policy must seek to re-establish harmony of local and foreign investment in collaboration, working in the national interest to achieve significant growth and better standards of living. We have in the past defined our national interests and safeguarded them against violation. We did this by carefully selecting only investment interests which would operate in harmony with our national interests to our mutual satisfaction.

No one can point a finger at any of those who are here; if they can, let them do so. Let them do so.

That successful record of the 60s is the same sort of successful record that we propose to carry on in the 1980s.

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Dealing with the taxation measures which we propose to offer in this year's Budget; we first of all face the position that there is a need to stimulate savings. To create a pool of investment to generate growth. As I said earlier, investment does not exist by itself. Savings are what constitute investment, providing the decision is taken to convert savings into investment. And growth is not possible without investment. If we are, therefore, intent upon achieving growth, we must be intent upon achieving investment and likewise we must be intent upon achieving savings.

I would like, therefore, to set out what measures the government proposes to adopt in terms of inducement to personal savings.

The first concerns income tax exemption of interest income from shares in Building Societies. At present, there is a limit of $600 on the exemption which an individual can claim in respect of exemptions from interest income from shares in Building Societies. It is proposed to move that $600 limit and replace it by a limitless amount.

That means you can invest as much as you wish in the shares of a Buiilding Society, the investment income from that will not attract any income tax providing the investor is an individual. This does not apply to corporations. Secondly, there are persons who invest in other areas in certificates of deposits, in banking institutions and in deposits in Credit Unions.

It has been decided to allow complete exemption of all interest earned from certificates of deposits in commercial banks and in credit unions and in any co-operative society which is approved, providing it is by an individual and not by a Corporation and providing the deposit is for a minimum of one year.

There are certain measures in addition to improve tax collection. The present situation is that companies and self-employed individuals are required each year before 15 March to estimate the amount of tax due by self-assessment and to pay this to the Commissioner of Income Tax in quarterly amounts. Where the taxpayer fails to do this, the Commissioner is empowered to make an assessment. The taxpayer can object to the assessment if it is disputed within 30 days.

What follows thereafter is a long, drawn out battle concerning the settlement of the objection, as a result of which millions of dollars are tied up on objections which are not settled.

It is proposed that a Notice of Objection by taxpayers to the assessment by the Commissioner will not be valid if not accompanied by a financial statement of Return Income Tax by the taxpayer within 90 days of the Commissioner requiring the taxpayer to enter such a return.

If the return is not made to the Commissioner within the 90 days, the Commissioner is empowered to confirm the assessment as final. But, we have to be practical. There is a limited number of accountants and auditors, most of them are very badly overworked and, therefore, for good and just reasons it might not be possible to meet the timetable. Hence, the Commissioner is also empowered to grant an extension in the event that the taxpayer says to him he is not able to render the account within 90 days.

He is empowered to grant an extension for a period which he will decide and, if he thinks fit, to make as a condition of the extension the payment of a small amount in the meantime.

Taxpayers may feel that because they are in the hands of a single individual, they may not be getting a proper decision and since this decision is vital to them, we have made a provision that the taxpayer may appeal the decision of the Commissioner in respect of granting the extension or in respect of the amount required as a condition of granting the extension and this appeal would be to the Revenue Board.

Now, the Revenue Board is a new concept, a new administrative unit which is about to be established in the tax structure of the country. It provides for 3 Revenue Board members, one of whom is the Chairman, and they will have under them the various tax departments. They, in turn, will have certain responsibilities whereas the departments will have others and by virtue of having a trio, or, as my friends on that side may say, "troika", it will be a much more acceptable position to taxpayers in so far as they are expecting and appearing to get justice in their complaints and in their objections.

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Another area in terms of saving foreign exchange is to deal with the question of hobby farmers. Presently, some persons engage in hobby farming and set off losses incurred against other income for the purpose of avoiding tax. Provision is to be made that losses arising from agricultural activity may be set off only against future incomes from that source.

Now, for the sake of accuracy and full information, I should indicate that the personal savings provision will come into operation on 1 July 1981 and it is for a trial period of one year to test how the flow of funds will materialize.

The measures designed to improve tax collection on the basis of a new assessment arrangement will come into effect on 1 October 1981 and the measures concerning hobby farming will come into effect on 1 January 1982.

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Agricultural incentives as I indicated earlier in my presentation are to be provided and on the basis that these incentives will be now on the same level as industrial incentives.

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But there is another area of incentives which we consider very important for agriculture, and that is the transport section. Right now, people who have trucks can't look forward to ever replacing them. The duties and the taxes that were piled upon vehicles of all sorts, including trucks, by the last government have rendered it impossible for any but the very rich to replace that kind of vehicle and especially when that vehicle is serving the commercial purpose of agriculture.

We have decided, therefore, to exempt from customs duty, retail sales tax and stamp duty, indeed, all tax and all duty, all trucks used for agriculture.

In keeping with our policy to make the rural areas more dynamic, and to bring them more into the mainstream of development, we recognize that there are trucks that ply the routes with passengers, that there are trucks that take goods to deliver to the small shops. One of the reasons why the shops on the top of the hills of the country could not get various items was because there were no trucks to distribute them.

We have decided, therefore, that all other trucks will be relieved of Stamp Duty and Retail Sales Tax. They will still pay Customs Duty.

What does this mean in costs? It means that a truck that costs $45,000 c.i.f., with the present duties and tax would sell for $97,930, and will now cost $54,000, a savings of $43,370.

A lesser truck that cost $36,000 and used to sell for $78,000 will now sell for $43,000.

For the non-agricultural truck that used to be imported at $45,000 to sell for $97,000, with the exemptions granted will now cost $65,000.

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And now I turn to the Budget.

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In so far as the Budget for 1981-82 is concerned, the deficit on recurrent account is $279 million as compared with $357 million in the last Budget and we are committed to progressively reducing this until we show a surplus.

On the basis of that deficit on recurrent account there is an overall gap in the financing of the Budget of $86.7 million. And normally, at this point, I would be saying to you that that gap has to be financed by taxation.

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That $86.7 million will not be financed by taxation; it will be financed by Treasury Bills. There will be no new taxation imposed this year.

But, I lodge a caveat. The revenues are over-stated by $35–$37.5 million. I didn't have to tell the House this. We expect to collect that by improvement in the collection of arrears. And it is entirely possible to do so but I give warning now that if there is any failure to collect it or any part of it, I will be coming back in the middle of the year for the balance.

There will be no printing of money unbacked by the Bank of Jamaica to finance this Budget.

The Budget financing has been designed in this manner to give the taxpayers of the country a rest after years of crippling taxation.

To give the country a chance to pull itself together and to produce growth again. But let us not forget that there are certain ceilings that we have to observe in the financing of the budget by agreement between ourselves and the Fund. The recurrent deficit must not exceed 3.5% of GDP. The overall deficit must not exceed 13.5% of GDP. And the total Budget outlay must not exceed 33% of GDP. This Budget has been financed within all those limits.

. . .

The Budget has been financed without a financial gap. There is no printing of money by the Bank of Jamaica to finance this Budget except in the interim period for cash flow purposes as is the normal course during the year. No new taxation will be levied this year if the $35 million put in for the collection of arrears is collected as we expect it to be.

Agricultural incentives increasing tax holidays on par with industry have been provided; full relief of taxes and duties on agricultural trucks reducing the cost by 80% has been provided; relief on Stamp Duty and Sales Tax for other trucks has also been provided; tax exemption on all interest earned by individuals on shares or deposits in Building Societies, Credit Unions and other approved Cooperatives has been provided.

Tax exemption on all interest earned by individuals on deposits of more than one year in commercial banks and other approved financial institutions under the Protection of Depositors Act has been provided.

Tax collection is to be improved by requiring taxpayers who object to assessment by Commissioner to file accounts within 90 days to substantiate their objection, or the assessment of the Commissioner will be binding. The taxpayer can seek extension of time from the Commissioner and can appeal against the decision of the Commissioner regarding extension.

The investment required to met the growth target for three years is four billion, six hundred million dollars. At this point, the only gap that remains in finding that sum is $820 million or 18%, a creditable amount at this time in terms of unidentifiable projects.

The growth targets are 3.7% for Year One; 4% for Year Two; 5% for Year Three . . . .

In next issues:

Taxation for development: corporate taxation in Japan
– by *Dharmendra Bhandari*

Tax incentives of industrialized countries for private undertakings in developing countries
– by *Eugen Jehle*

Safe harbor leasing - a controversial means for distribution of investment incentives
– by *Frank Schuchat*

The development of double taxation conventions with particular reference to taxation of international air transport
– by *D. Hund*

The welfare cost of taxation: its meaning and measurement
– by *Nizar Jetha*

The Peruvian tax reform (1981)
– by *Pedro Massone*

HONG KONG:

Tax Aspects of Foreign Currency Gains

by I.W. Harris*

I. INTRODUCTION

In researching for this talk I was surprised to find, or, perhaps I should say, not to find, how little has been published on the topic and how few decided cases exist. However, on reflection, this is perhaps not surprising as it is only comparatively recently that exchange differences have actually emerged as an accounting problem, let alone a tax problem. Although I do not intend to clutter up this talk with a learned discourse on international exchange rates, it may help in order to put the problem in its correct perspective to spend a few minutes on the history of exchange rates.

In the so-called good old days, trade was financed by one of two principal means – by barter or by payment in a precious commodity, generally gold, perhaps silver and, in this part of the world, opium. On the whole, until the outbreak of World War II, the currencies of the world's major trading nations remained on a par with each other, with the U.S. dollar and the pound sterling being exchanged on a 1 to 4 basis and it being true to say, therefore, the old 2/6d coin was really "half a dollar". The first major upset to this pleasant state of equilibrium occurred in the late 1940s when Britain, which at the time was undergoing a severe financial crisis, devalued the pound against the U.S. dollar from $4 = £1 to $2.80 = £1. This was followed in 1967 by a further devaluation which brought the rate down to $2.40. This event seemed to open the floodgates of change and spawned such features of current monetary policy as Special Drawing Rights, the European Monetary System's "Snake" and of course the move of gold away from the fixed parity with the U.S. dollar.

So where has all this left the businessman and his tax adviser? First and foremost it has meant that any transaction entered into by the businessman involving a foreign currency has an exchange risk attached to it – no longer can he assume that if he purchases a machine for, say, US$10,000 when the rate is HK$5 = US$1 that therefore on delivery he will need to shell out, say, HK$50,000 – it may cost him HK$55,000 or, if he is lucky, HK$45,000. He may have sold some goods to a dealer in the United Kingdom for £1,000 which at the exchange rate then prevailing would have yielded HK$10,000, but when he cashes the draft he only receives HK$9,500 or again, if he is lucky, perhaps HK$10,500. The businessman may have invested some of his profits into Australian real estate or German shares or Japanese bonds – what does he do at the end of the year when translating the value of his investment? He finds it is worth less than he paid for it – or, if he has guessed correctly, it is worth more.

Fortunately for me it is no part of this paper to delve into the complexities of currency hedging, swap transactions and the like, nor indeed is it any part of this paper to discuss the various highly technical reasons that cause exchange fluctuations, nor even the theoretical side of the pronouncements of the various accounting bodies on the treatment of this subject, although some brief consideration is necessary in respect of all 3 topics in order to cover this particular subject in the required depth.

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* Group Tax Adviser, The Hongkong and Shanghai Banking Corporation, Hong Kong. This paper was read at the *Asian-Pacific Corporate Tax Symposium*, 25-27 November 1981, Hong Kong.

II. WHAT IS A CURRENCY GAIN OR LOSS?

I am not going to attempt to define what is an exchange gain or loss as this is a field more appropriate for our accountant or lawyer friends who can expound no doubt at great length on the situations in which a businessman can find himself when involved in foreign currency. However, for the purposes of this paper it is probably sufficient to define a currency gain or loss in 2 parts:

(a) where an obligation has to be met or an item of income is taken into account which produces less or more in the local currency than when the transaction was originally entered into;

(b) where at a particular date the value of a foreign currency denominated asset or liability reveals a surplus or a shortfall when translated into local currency.

III. ACCOUNTING TREATMENT

A. Normal exchange fluctuations distinguished from major changes in currency parities

For Hong Kong companies engaged in substantial overseas trade, or owning substantial overseas trading branches or subsidiaries, the normal fluctuations of exchange rates, whether the rates are pegged or floating, may give rise to differences on exchange whenever one currency has to be converted for accounting purposes into another. Such gains and losses on exchange are a normal feature of overseas operations and do not in themselves usually present any special problems. In general, where there has been no substantial shift in parities, exchange differences on direct trading with foreign customers or suppliers are dealt with in the profit and loss account in arriving at the profit or loss for the period. Where the accounts of overseas branches or subsidiaries have to be converted into Hong Kong dollars for inclusion in the parent's or group accounts, the normal accounting conventions for conversion are straightforward and are used consistently from year to year.

Where, however, exchange rates are subjected to a sudden significant and evidently permanent adjustment outside the run of normal exchange fluctuations, companies may encounter special accounting problems. In these circumstances exceptional exchange gains or losses attributable to the abnormal change in parities may arise as regards both direct trading transactions and the accounts of overseas branches and subsidiaries. It then becomes necessary to determine the amount of exceptional loss or gain involved, and how it should be dealt with in the accounts.

In broad theory, the loss or gain attributable to a change in parities could be most directly arrived at by converting overseas assets and liabilities at the date the rate changes into local currency first at the old rate and then at the new: the difference between the local currency equivalents, after taking account of any forward transaction in overseas currencies, including any forward purchases and sales of goods, is the exceptional gain or loss attributable to the shift in parities. In the case of overseas branches and subsidiaries the exceptional gain or loss is in practice generally computed by means of adjustments applied to their assets less liabilities at the balance sheet date. The gain or loss computed, if material, should be segregated from "normal" exchange gains or losses (which, as noted, are generally dealt with in the profit and loss account in arriving at the profit or loss for the period), and separately disclosed whether (a) as an exceptional item entering into the computation of the profit or loss for the period, or (b) as an exceptional item shown separately after "profit after taxation". When the latter treatment is adopted, account has to be taken of any consequential effect on the tax charge and disclosure made of such adjustments as are necessary. Where a company or group has extensive interests overseas and fluctuations in local currency equivalents or overseas assets and liabilities are a recurrent feature, the treatment in (a) above may be preferable unless the amount involved is exceptionally large; in other instances the treatment in (b) may be more appropriate. An alternative to the treatment in (b) is for the exceptional gain or loss (so far as it may be regarded as being of other than a revenue nature – for instance, as arising on the re-statement of currency fixed assets at the new rates) to be dealt with by a direct transfer to or from reserve, if this would facilitate the presentation of a true and fair view.

The identification and treatment of exceptional gains and losses attributable to major changes in exchange parities are dealt with below in 2 parts: first in the context of overseas transactions or locally based companies not involving overseas branches or subsidiaries; and second, in the context of the conversion into dollars of the accounts of overseas branches and subsidiaries.

B. Overseas transactions of locally based companies not involving branches or subsidiaries

For companies with overseas assets and liabilities other than those attributable to overseas branches and subsidiaries, a major change in currency parities will give rise to a local currency gain or loss on exchange in respect of those of their overseas assets or liabilities affected at the date currency rates change.

In these circumstances the general rule is that overseas assets and liabilities, both current and long term, at the date the parities change should be converted into local currency and the new rate of exchange and the resultant exceptional losses or gains on exchange, if material, presented in the accounts so as to show a fair view of the effects of the alteration in exchange parities.

Exceptional gains or losses on exchange attributable to changes in parities and relating to overseas assets and liabilities of a normal trading nature are normally dealt with in the profit and loss account, and separately disclosed as an exceptional item, if material. Due account is taken of any consequential effect on liability to tax.

There may be exceptions to the general rule to the extent that any part of the gain or loss may properly be taken into account in arriving at the amount at which items to which it relates are to be stated in the balance sheet. For instance, that part of an exceptional loss on exchange attributable to goods unsold on the balance sheet date may be treated as an increment in cost provided net realisable value in local currency is estimated to be in excess of cost so computed; this treatment is preferable if local currency prices of the items on hand have been increased to compensate for the change in parities.

Similarly, exceptional losses or gains attributable to liabilities outstanding at the relevant date for purchases of fixed assets from overseas are normally dealt with by adjustment of the cost in local currency of the relevant asset account.

The amount attributed in the balance sheet to work in progress on long term contracts involving overseas customers or suppliers will require review in the light of altered exchange parities so that provision can be made in the normal way for any foreseeable loss arising therefrom.

Exceptional gains or losses which may be regarded as not of a revenue nature, such as those relating to long term loans granted or received, may be shown in the profit and loss account or dealt with by direct transfer to or from reserve according to which method will better present a true and fair view, as suggested above. Where there are both gains and losses of other than a revenue nature, they are set off in the first instance.

C. Locally based companies with overseas branches or subsidiaries

The object of converting the accounts of locally based companies' overseas branches or subsidiaries into local currency is to enable them to be incorporated into the home company's or group accounts at a local currency equivalent which fairly expresses their state of affairs and results. Normally the 2 main methods of converting other currencies for this purpose are the "closing rate" and "historic rate" methods.

Where a major revision of exchange parities has taken place during the financial period it is necessary to determine whether the effect on the local currency equivalent of overseas branches' or subsidiaries' accounts gives rise to an exceptional difference on exchange. In theory, as noted above, the gain or loss attributable to a change in parities could be directly arrived at by converting the accounts of the overseas branches or subsidiaries at the dates the rates changed into local currency at the old and new rates and measuring the difference.

In practice the exceptional gain or loss attributable to the change in parities is normally calculated by adjustment of net assets in the opening or closing balance sheets; for instance, by taking net assets at the last accounting date before the change and adjusting them by reference to the profit earned or loss incurred in the period up to the date of change, the difference between the resultant amount converted at the old and new rates of exchange is the exceptional gain or loss. This achieves the same result as converting net assets at the date the rates changed. Since the "historic rate" method of conversion uses the average rate of exchange for the year to convert profits or losses (before charging depreciation), it automatically takes account of the effect of any change in parities; the "closing rate" method does not, and in that case to determine the exceptional difference on exchange it is normally appropriate to apportion profits or losses to the date the parities changed and to convert results up to that date at the old rate and after that date at the closing rate. In making this calculation, results should be apportioned as nearly as possible on an actual basis so as to take due account of seasonal or other fluctuations in trade. Turnover should be apportioned and converted in the same way so as not to present a misleading view of trading and results.

Under the "closing rate" method, assets and liabilities at the balance sheet date are converted at the rate of exchange then ruling, so that the effect on them of any major change of parities is automatically recognised. Under the "historic rate" method, however, fixed assets and long term loans and liabilities are normally stated at their original local currency equivalents. A major change in parities calls in question these amounts. Bearing in mind that proper provision must be made for depreciation of fixed assets and repayment of long term liabilities, it would be unrealistic not to recognise that a change in parities implies an adjustment in the local currency equivalents of fixed assets and long term loans. In these circumstances it may be desirable either to adjust their local currency amounts by reference to the balance sheet rate of exchange, or to carry out a valuation of fixed assets; if the "historic rate" method of conversion is to be followed, the latter amounts would continue to be used for future conversion purposes in place of original local currency equivalents. Whichever basis of conversion is used, fixed assets appearing "at cost" in terms of overseas currencies may normally continue to be so described after conversion into local currency, since the position will be made sufficiently clear by disclosure of the basis on which foreign currencies have been converted into local currency.

IV. WHEN DO GAINS AND LOSSES OCCUR?

As can be seen from the introduction to this paper, an exchange gain or loss can be said to arise at a number of different points in time. For instance, on a sale of goods contracted at a particular price the gain or loss could arise when the price for the sale of the goods is paid, or when they are actually received or, if deposited in an overseas bank account, when the proceeds are eventually remitted. However, as a general principle it is probably safe to say that the Revenue would normally follow generally accepted accounting principles such as those that I have mentioned earlier. I will revert in more detail later, but it should be noted that although accounting principles would generally apply as to when a gain or loss arises, it does not follow that this follows for a determination as to whether it is of a revenue or capital nature.

V. TAX TREATMENT OF GAINS AND LOSSES

As I have just mentioned, despite the accounting treatment of a gain or loss, the Revenue will apply their own rules to determine whether it is of a revenue or capital nature. What are these rules? The same general principles apply to currency gains and losses as apply to other items of income and expenditure, but because of the very special nature thereof there exist certain peculiarities which are worth examining in some detail.

A. Capital transactions

If a taxpayer purchases fixed assets from abroad and before he makes payment for them a loss or profit results due to the intervention of a change in exchange rates, such a loss or profit would be on capital account. An incidental result of this would be that the asset could have 3 different cost prices, i.e. the cost at the time of incurring the obligation to pay for it, the cost of acquiring the foreign currency to pay for it and the cost which would be relevant to the computation of capital allowances. For example, a local ship owner contracts to buy a ship from the U.K. for HK$5M. The ship is delivered in the same year but payment is not made until the following year. During the intervening period the Hong Kong dollar is revalued by 10% and therefore in the following year the shipowner will gain HK$500,000 as he will only need to pay HK$4.5M to settle the debt. The ship in his books will continue to show the figure of HK$5M although the real cost to him will only be HK$4.5M. The gain here will be on capital account and this may be taken up in his profit and loss account, but below the line.

For tax purposes the Revenue will adjust the cost to HK$4.5M for the purposes of calculating initial and annual allowances. Of course the converse would apply if an exchange loss had been made on the transaction. It will be seen from this example that for tax purposes the actual outlay of currency by the taxpayer is taken as the cost for the purposes of capital allowances and the corresponding gain or loss is excluded from the profit for tax purposes.

Similarly, the discharge of a foreign loan can result in exchange losses or profits should there be fluctuations in the exchange rates by the time the loan is repaid. It should be noted, however, that loans in this context do not include outstanding balances on trading accounts; exchange gains or losses resulting from this transaction are of a revenue nature.

B. Revenue transactions

Any exchange differences which relate to a taxpayer's income earning operations or form part of his business or are directly or sufficiently related to his business operations will be taxable or deductible as the case may be. For example, if a local importer purchases goods from Japan and prior to the settlement of the purchase price the Japanese yen is devalued he will require fewer Hong Kong dollars to discharge the yen debt. The acquisition of yen to discharge the debt is closely connected with his income earning operations and consequently the gain he makes will be subject to tax.

C. Onshore or offshore

In most jurisdictions it is irrelevant whether the gain or loss was made onshore or offshore as both will come within the tax net. However, in a source jurisdiction such as Hong Kong, the matter is very relevant. The Hong Kong Inland Revenue Department have not, as far as I am aware, issued any guidelines other than a circular issued after the 1967 devaluation of sterling which admitted that the problem was complex and that each case would have to be examined separately. However, as we are only concerned with gains and losses of a revenue nature it is difficult to imagine many circumstances where a normal trading concern in Hong Kong would be able to incur an offshore exchange profit of a revenue nature as it is the underlying transaction, i.e. the sale of goods, which has to be looked at. This matter will, however, be discussed later when we come to minimisation.

VI. TAX CASES

Perhaps there is no clearer way of illustrating the complexities of this subject than by a review of the various judicial decisions that are available.

The only Hong Kong case that has come to the attention of the Courts is that of the Commissioner of Inland Revenue v. Li and Fung Limited which is reported in the 10th Supplement to the Hong Kong Tax Cases. The facts were as follows:

The Company carried on business as exporters and general merchants; its business included exporting Hong Kong manufactured goods to the United States. Such goods were paid for in U.S. currency and the proceeds were deposited in banks in the United States on 7-day call. At various times, when better rates of exchange between the U.S. and the Hong Kong dollar could be obtained, the accumulated funds with interest thereon were remitted back to Hong Kong. When preparing accounts for the year ended 31 December 1972 the Company was aware of the impending devaluation of the U.S. dollar and accordingly revalued the amounts of its cash and bank balances, trade debts and credits expressed in U.S. dollars, resulting in a net loss of HK$333,296.76.

On 12 February 1973 the U.S. dollar was in fact devalued and the Company claimed a deduction for the loss shown in the 1972 accounts against its assessable profits for 1974/75. The Assessor disallowed the amount of HK$327,750 relating to revaluation of the cash and bank balances on the grounds that this was a loss of capital.

On Appeal the majority of the Board of Review found that the U.S. dollar balances, being the proceeds of sale of goods and therefore income from trading, did not lose their identity as trading income by being retained in the U.S.A. and the loss was therefore allowable. The minority view held by one member was that the retention of the money in U.S. dollars placed on deposit altered the nature of the funds from trading income to investment. The Commissioner appealed.

Mr. Justice Garcia held that although the sums in question originated as trading income, their nature was altered to that of capital investment when accumulated and placed on deposit in U.S. banks with the intention of obtaining more favourable exchange rates. The Commissioner's appeal was allowed.

Two Australian cases are of interest and are useful guides. The first is Federal Commissioner of Taxation v. Cadbury-Fry Pascall (Australia) Limited (79ATC4346) which was heard in the Supreme Court of Victoria. The facts were as follows:

Cadbury-Fry Pascall (Australia) Limited was a subsidiary of an English company which manufactured confectionery for sale in Australia. Two of the materials required for the manufacturing process were cocoa beans and cocoa butter which were purchased from West Africa. Under a long-standing arrangement the English parent placed orders for these items on behalf of the taxpayer with the supplier in West Africa and paid for these goods on the Australian company's behalf. Regular statements of the amounts due to the parent company were sent to the subsidiary and this debt was included in the subsidiary's loan account. Interest was charged by the parent on this account and settlement was made by the subsidiary generally some 6 months after the debt was incurred. It was part of the arrangement between the 2 companies that the debt should be paid in sterling. The loan account also reflected transactions relating to purchases of material made directly by the subsidiary from the parent and also purchases of plant and equipment made through the parent. In addition, service charges made by the parent were passed through this account. As a result of the sterling devaluation in November 1967, the taxpayer was required to pay fewer Australian dollars than had earlier been estimated. The taxpayer claimed that the part of the exchange gain thus made which related to the purchases of raw materials made by the parent on the subsidiary's behalf was not assessable. The taxpayer argued that the arrangement between it and its parent was to provide an advance of funds and that therefore payments in reduction thereof were of a capital nature. The case went to the Board of Review who upheld the taxpayer's claim and thereafter the Commissioner appealed to the Victoria Supreme Court. It was held by the Judge that the arrangement between the subsidiary and its parent was not for the purpose of providing the subsidiary with an advance of funds but that the payment in reduction of the loan account was in substance part of the regular outlay of the taxpayer for raw materials regularly required by it for manufacturing purposes. The mere substitution of the parent for the supplier was an incident of the commercial operation and did not affect the true nature of the transaction. It was held, therefore, that the gains made on that part of the loan account which related to the purchases of raw material and the service charges were subject to tax but the Commissioner agreed that the gain made on purchases of the plant and equipment was not taxable.

A more complex case was that of Lombard Australia Limited v. Federal Commissioner of Taxation (80ATC4151) which was heard in the Supreme Court of New South Wales. The facts in this case were that Lombard Australia Limited, which was a wholly owned subsidiary of the U.K. based National Westminster Bank, borrowed money from several overseas sources, including its parent. These funds were used for the general purposes of its business and were generally for a period of 5 years. At the same time, Lombard Australia Limited also raised funds in the Australian market. After 1975, the company conducted a policy of gradually reducing its foreign currency borrowings and relied more extensively on local fund raising. During the year ended 31 December 1975 Lombard Australia Limited repaid certain overseas loans and sustained exchange losses of $3.2M and claimed this as a deduction in its tax return for that year. Mr. Justice Powell held that the losses were deductible and that they were properly treated as losses or outgoings necessarily incurred in the income earning process. The Judge said that the evidence showed that at all relevant times borrowing overseas was an integral part of the process by which not only the taxpayer but most, if not all, major financiers in Australia funded their lending activities. The evidence also showed that at all relevant times fluctuations in the value of currencies were an established feature of the worldwide monetary scene. This being so, the losses in question represented a kind of casualty, mischance or misfortune which is a natural or recognised incident with the particular trade or business. In his summary the Judge referred to the Cadbury-Fry case referred to above and said that the facts were similar in both cases as the transactions with the overseas parent related to transactions which related to trading stock.

The 2 Australian cases illustrate the rule that it is not the actual transaction that must be looked at to determine whether an exchange gain or loss comes within the tax net, but the underlying transaction to which it relates.

In the U.S., where surprisingly enough there are no detailed regulations covering currency gains and losses, much reliance is placed on decided cases to establish the rules.

One of the leading cases was heard in April 1979, the Hoover Company case (72TC206), where the tax court held that gains and losses from a taxpayer's transactions in foreign exchange contracts were capital gains or losses and not ordinary gains or losses. The Court concluded that the transactions related to taxpayer's ownership or stock in its foreign subsidiaries rather than the taxpayer's everyday operations. This was despite the fact that the Hoover Company entered into a considerable number of foreign exchange contracts, most of which resulted in losses. This was contrasted with the Corn Products case (350US46/1955) where similar transactions were entered into but related to the taxpayer's everyday operations.

A useful case was heard in Malaysia in 1973 (L Sdn Berhad v. Comptroller General of Inland Revenue 1973 1MLJ56). The facts in this particular case were that the company was carrying on the business of buying and selling land and part of the proceeds from these transactions were deposited in the U.K. When sterling was devalued the company incurred a loss of M$595,840. The taxpayer claimed this as an allowable deduction but the claim was dismissed and the Judge said that one of the major questions which arose before the special Commissioners was whether the taxpayer's money in London was fixed capital or circulating capital. He agreed that in the light of decided cases if the money in London was circulating capital then the loss would be an allowable deduction. It would be otherwise if it was fixed capital. It is implicit that the manner in which the capital is employed is a material factor in determining whether it is fixed or circulating capital. The Judge went on to say that it did not seem to be part of the taxpayer's case that the money in London had been employed in any manner for the company's business which of course was buying and selling land in Sabah.

Judge Ali concluded by saying, "The assertion by the taxcpayer that the money could be used any time if needed for the company's business is neither here nor there. I venture to think that the taxpayer has not suffered any loss known to law."

Finally, we must have a look at the various U.K. tax cases on this topic. Not unnaturally, the U.K., having certainly in the past one of the world's major trading currencies and relying to a great extent on case law to decide matters of principle, have produced a number of interesting cases over the years. One of the earliest cases was that of Bennett v. Underground Electric Railway Company of London Limited (1923ATC4275) where the taxpayer claimed as management expenses a deduction for the additional costs incurred in purchasing U.S. dollars with which to pay interest in New York. The judgement was that the management of the company did not alter whether or not the interest was paid in dollars and therefore at a greater sterling cost and accordingly gave judgement in favour of the Revenue. The next case was McKinlay v. H T Jenkins and Son Limited (10TC372) where a U.K. company imported marble from Italy and remitted to a bank in Italy sufficient funds to meet advanced payments for the quantity of marble. Before the supplier needed to be paid, the sterling/lira rate moved and as a result a large profit accrued to the U.K. company on sale of the lira. The exchange rate then moved in the opposite direction and the U.K. company was able to acquire the lira cheaper to pay off the Italian exporter. Mr. Justice Rowlatt held that the profit was no more in effect than a bare exchange transaction in the nature of a speculation and that the profit from such transactions could not be a trading profit of the company since it was no part of the company's business to deal in exchange. Another pre-war case was that of Imperial Tobacco Company of Great Britain and Ireland Limited v. Kelly (25TC292) where the company acquired U.S. dollars each year to finance its purchases of tobacco leaf. On the outbreak of war the company had certain funds in U.S. dollars for this purpose which it was required to sell to the U.K. Government. A profit was made and it was held that such a profit was subject to tax because the dollars were acquired for the purposes of a trading transaction. A case a little nearer to this part of the world was Davies v. The Shell Company of China Limited (32TC133) where the company had a large number of agents in China who were required to place deposits with the company. These deposits at the outbreak of the Sino-Japanese war amounted to some 7 million Chinese dollars and were placed on long term deposits with banks. It was agreed that interest was payable to agents on the deposits and at the outbreak of the war the company converted these deposits to sterling and repatriated the funds to the U.K. As each agency became renewable the company terminated the agency and repaid the agent his deposit. On account of the depreciation of the Chinese dollar these payments gave rise to substantial sterling deposits. The U.K. Court of Appeal decided the company's deposits were fixed capital and the profits in question were not trading receipts.

A post-war case which in fact is still going through the U.K. courts is that of Pattison v. Marine Midland Bank Limited, and in May of this year the Chancery Division found in favour of the Crown, but it is understood that the bank are considering appealing against the decision. The facts in this particular case were that Marine Midland Bank Limited is a subsidiary of an American bank who borrowed dollar funds by issuing loan stock to 2 subsidiaries of its parent company resident in the U.S. These funds were lent on to dollar and other foreign currency clients. The loan stock was cancelled by repayment of the loan on 15 June 1976. The company did not speculate in foreign exchange transactions but looked for its profits to the interest differential between amounts lent and amounts received on deposit and for the most part the borrowings were matched by loans. As a result of the fall in the value of sterling an exchange loss was shown on repayment of the loan stock and gains were shown on the assets matching the loan stock translated into sterling on the relevant balance sheet dates. At no time was there any actual conversion into sterling. The taxpayer company was assessed to corporation tax on the basis of exchange loss arising on the payment of the loan stock as a capital loss and the exchange profits shown on the matching assets were revenue gains. The taxpayer company appealed to the City Commissioners contending that the loan stock did not represent capital employed in the trade and any exchange loss was a revenue loss deductible from trading profits. The Commissioners determined that neither the exchange loss nor the exchange profits were to be taken into account in computing the taxpaying company's liability to tax. The Crown appealed to the Chancery Division where it was held that since the loan stock formed part of the capital structure of the company and the liability to pay it was a capital liability, the deduction of the exchange loss sustained on repayment from trading profits was prohibited. The exchange profits shown in the balance sheet in respect of the matching assets however were revenue profits to be taken into account in computing liability to tax.

VII. MINIMISATION TECHNIQUES

The wide variety of cases referred to just now indicates that there are numerous ways in which currency gains and losses can arise and it is clear that careful consideration needs to be given to the tax effects of exchange related transactions. However, it should be borne in mind that the first priority should in all probability be to reduce the risk of the exposure itself of a currency change. This of course is necessary unless the tax planner can ensure that all exchange losses will be deductible in high tax areas and all exchange profits are taken in low tax or nil tax countries, or, alternatively, all losses are of a revenue nature and all profits are of a capital nature.

A. What is currency exposure?

Currency exposure is the net amount of a firm's assets and liabilities in a foreign currency. A net asset position is also called a "long" position, a net liability position a "short" position. The exposure risk is consequently the risk of a monetary loss due to exchange rate fluctuations. It depends both on the size of the exposure and the extent of the expected re- or devaluation of a currency in terms of the base currency.

Currency exposure can be calculated basically in 3 ways:

1. *Transaction exposure* covers those assets and liabilities which, in the short or medium term, will result in an actual currency conversion. Any change in the value of the respective currency between the date on which an asset or liability is created and the actual conversion date will result in an immediate, actual gain or loss on exchange. This exposure consequently covers all transactions involving foreign currencies such as imports and exports of goods and services, payments of royalties, etc.

2. *Translation exposure* is the exposure calculated on the basis of the balance sheet of the foreign operation. It includes both the amounts of the transaction exposure and all other items which will cause a profit and loss effect on consolidation if the currency in which they are denominated changes in value. It therefore also comprises assets and liabilities which will not give rise to an actual gain or loss on exchange as these items will not be liquidated in the short or medium term. Nevertheless, the translation of these items will result in an accounting (i.e. unrealised) gain or loss, if the currency in which they are expressed changes in value as compared to the base currency.

3. *Economic exposure.* As gains/losses resulting from the economic exposure are not reflected in the financial statement as realised or unrealised exchange gains/losses but a sordinary trading income with no special tax implications, currency exposure, in what follows, will refer only to transaction and translation exposure.

B. How to minimise exposure

The 2 basic methods are:

(a) *Forward exchange contracts/swaps*

By way of forward exchange contracts the firm can shift its exposure to another party, usually to a bank, for a cost which will be based on the interest differential between the local currency and the foreign currency. If an exposure is the result of a temporary loan, the firm can make a swap, i.e. it sells the local currency at the present (spot) exchange rate and, at the same time, re-purchases the local currency at the applicable forward exchange rate.

(b) *Invoicing in the base currency*

This is the hedging method for firms which export directly to third party customers. As the exposure risk is passed on to the customer, it requires a certain bargaining strength and may not be possible in highly competitive markets unless the hedging costs are reflected in the price.

Re-invoicing can be the solution to this dilemma. The exporting company invoices in the local currency to a re-invoicing centre which is to carry and manage the exchange risk. Re-invoicing for a group of companies has the additional advantage that payables/receivables in the different currencies can be netted thus reducing transfer charges and exchange costs.

C. The tax effects of exposure management

As in all business decisions care must be taken to ensure that the tax effect of any transaction is known in advance so that at least the possible liability is known and at best so that the transaction can so be structured to the best possible advantage. Foreign exchange transactions of necessity require that the tax planner is aware of the law and practice relating to such activities not only in his home jurisdiction but also in other countries where the taxpayer operates. This is because of the varying tax rates involved, but more importantly the differing tax treatment accorded to foreign exchange. Thus in the Netherlands the Revenue do not distinguish between capital and revenue, whereas in Germany unrealised gains are not taxable until recognised wherever unrealised losses are deductible when incurred.

VIII. CONCLUSION

In concluding this short talk I hope that I have been able to shed some light on this complex problem. In the days of sailing ships and fixed parities of currencies, currency gains and losses rarely arose, and, if they did, were readily identifiable as to nature and source. However, with the vast sums neeed for international finance these days and with the speed that not only currencies can fluctuate, but also funds can be transferred, it is important for the tax planner to be fully aware of the consequences of international transactions.

CHINA:

China's Recent Tax Experiments to Revive the Industrial and Commercial Tax System of State enterprises

By Jap Kim Siong *

Contents

I. INTRODUCTION

Important changes in economic development policy are taking place in the People's Republic of China since the Government's announcement that it intends to achieve the declared goals of the Four Modernizations – in agriculture, industry, defense, and science and technology – by the end of this century. This modernization program is the start of a new venture in China's economic development strategy since the establishment of the People's Republic of China on 1 October 1949 and naturally not without consequences to taxation matters.[1]

The tax system of each country, in order to be an effective part of its economic development policy, must be tailored carefully to the peculiar circumstances and objectives of that country. China has chosen the road to socialism. The crucial point which emanates therefrom is the collectivization of ownership of the important means of production, such as land, capital and labor.[2] Socialization of the means of production connotes the transfer of private ownership of the means of production into public and collective ownership.[3] In China, even private ownership of dwellings has been eliminated by the socialization of the means of production. Only recently have flats been for sale for private ownership.[4] By and large, the means of production (land, capital and labor) are allocated by the State according to the national economic production plan. Consequently, the decisive role of production and consumption under a free market economy or where the price mechanism rules has been replaced by State planning. The price fixing system of commodities in the planned economy in China has caused a deterioration in the balance between prices set by the State and the actual market value. Consequently, it is generally conceived that the economic set-up at present no longer suits the goal of achieving high sustained economic growth after 30 years of socialist economic planning.[5]

China introduced its own tax system in 1950 and adopted "the policy of utilization, restriction and transformation", which translates into plain terms as the transformation from private ownership into public ownership of the means of production during the transition period of the early 1950s. The basic 1950 tax system was followed by tax reforms in which the tax system of State enterprises was more finally attuned to the socialist economic system by turning the advantages of the advances of production to the benefit of the people instead of private entrepreneurs.[6]

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1. See: Y.C. Jao, "Recent developments in China's tax system", *Bulletin for International Fiscal Documentation* 35:1 (1981), 16 ff; Guo Hongde, Wang Wending and Han Shaochu, "The reform of the industrial and commercial tax system will serve the 'Four Modernizations'", *Jingji Guanli* (Economic Management) 1980:3, 18 ff.
2. E.L. Wheelwright and Bruce MacFarlane, *The Chinese road to socialism* (Harmondsworth: Pelican, 1973).
3. "Two types of ownership", *Beijing Review*, 11 February 1980, 14.
4. "Flats for private ownership", *Ta Kung Pao* (Hong Kong), 3 July 1980.
5. Gao Zhihua, "What is the best economic set-up for China?", *Social Sciences in China* 1980:1, 7 ff.
6. Liu Zhicheng, "On the reform of the industrial and commercial tax system in our country", *Jingji Guanli* (Economic Management) 1980:9, 23 ff.

In the wake of the Cultural Revolution (1966-1976), the benefits of taxation were not accepted and it was not until recently that the idea of taxation has been revived as a means of providing incentives for greater efficiency and productivity in the use of scarce means of production in State enterprises.

State enterprises are subject to the profit allotment system in which enterprises have to transfer all their profits to the State and, by the same reasoning, all losses are automatically covered by State subsidies. In addition, workers are hired but not fired, promoted but not demoted: a phenomenon known as the "iron rice bowl". This was considered for a long time a sign of "the advantages of socialism". This system of overall State responsibility in production, distribution of goods, social welfare and in other social and economic fields is known as "everybody eats from the same rice bowl". One may compare it with a national social security system for the entire country.

From a functional point of view, however, the profit allotment system replaced the price mechanism to equalize supply and demand of goods in the planned economy. It is obvious that the system of the "iron rice bowl" provides hardly any material incentive for greater efficiency and productivity in the production of capital and consumer goods. The crucial point is that efficient or inefficient functioning of the economy does not depend on who owns the means of production but on the efficient or inefficient operation of the means of production, irrespective of whether it is in a centrally planned economy or in a free market economy.[7]

If the means of production owned by the people are left idle or are badly operated, their economic value is not used. To introduce more vitality in the economic structure, limited competition in a planned economy with State ownership of the means of production and taxation as an instrument to achieve equilibrium between supply and demand may play a role. Higher taxes can be levied on goods whose production needs to be curtailed, and reduction or exemption from taxes can be granted for goods whose production must be encouraged. Besides tax policy, other measures (e.g. price policy, the supply of materials, investment policy, credit and loan policy) may also be applied.[8] The new policy should emphasize the use of "tax instead of profit, independent accounting and self-responsibility for profit and loss."[9]

Since China has nearly 400,000 State enterprises operating in the fields of industry, commerce, communication and transportation, accounting for 64.7% of State revenue in 1960, as against 13.4% in 1950 (see Appendix A), the introduction of taxes to play a role in Government policy to reform the national economic set-up will be implemented gradually during a transitional period of several years, and not overnight by one law as was the case with the introduction of the income tax on joint ventures and the individual income tax effective as of 10 September 1980.[10]

At present, foreigners residing or operating a business in China can be subject to the following taxes:
- the individual income tax;
- the income tax on joint ventures;
- the industrial and commercial income tax;
- the industrial and commercial consolidated tax;
- the urban real estate tax;
- the tax on vehicles and ships;
- foreign enterprise income tax (see Appendix B).[11]

However, the purpose of this article is to explore and focus on the almost imponderable tax aspects of the gradual expansion of self-responsibility of State enterprises for their respective profits and losses. The term State enterprises may include factories, department stores and retail shops run by the State. It should also be noted that the tax experiments undertaken in chosen pilot enterprises are so various in number that attempting to obtain a complete concept of the prospective tax changes can be little more than crystal-gazing.[12]

II. PROBLEMS ARISING FROM THE RESTORATION OF SELF-RESPONSIBILITY OF STATE ENTERPRISES FOR THEIR OWN PROFIT AND LOSS

By and large the profit allotment system will be phased out in 2 stages. The first stage is that enterprises will be allowed to retain a portion of their acquired profits after turning in their planned profits to the State. The State assigns them a basic production schedule to be fulfilled, but each enterprise can increase its own production using its own initiative . The retained profits can be used by the enterprises for expansion of production or for the safety and welfare of the workers. The portion of retained profits differs from location to location in the country and depends on the kind of activity of the enterprise, such as manufacturing, transportation or commerce.[13] For example, in the Municipality of Shanghai, 2 profit retention systems were put into force for trial implementation. In 1978, spinning and weaving enterprises were allowed to retain 9.5% of the profits for allocation to special funds while 90.5% went to the State; they were allowed to retain their total profits for 5 years beginning in 1979. For metallurgical enterprises, the profit retention ratio in 1978 was set at 40% with 60% allotted to the State.

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7. See: George N. Halm, *Economic systems. A comparative analysis,* third edition (New York, 1968), 32 ff.
8. Xue Muqiao, "A study in the planned management of socialist economy,,, *Beijing Review,* 26 October 1979, 14.
9. "Make a good job to substitute tax for profit, promote increased production for increased income. Shanghai Light Industry Machinery Corporation", *Jingji Guanli* (Economic Management) 1981:6, 44 ff.
10. "Law of the People's Republic of China concerning income tax on joint ventures between Chinese and foreign investments", *Official Gazette of the State Council of the People's Republic of China,* 15 November 1980, 397 ff; "Individual income tax law of the People's Republic of China", *Official Gazette...,* 15 November 1980, 397 ff.
11. Zhao Suzheng, "What taxes should foreigners pay in China?", *Beijing Review,* 26 October 1981, 20-21.
12. See: "Eighty examples of the system of economic responsibility in industrial production. Compiled by the Investigation and Research Department of the State Economic Commission", *Jingji Guanli* (Economic Management), 1981:10, 17-35.
13. "Circular of the Ministry of Finance concerning measures for State owned industrial enterprises to retain profits for trial experiment approved by the State Council on January 22, 1980", *Official Gazette...,* 8 March 1980, 6-10.

They were allowed to retain their total profit for 5 years beginning 1979.[14]

However, the most important development affecting the taxation of State enterprises in China is the last stage, the experiment with financial self-responsibility for one's own profit and loss. Instead of handing over a portion of their profits to the State, the enterprises pay *taxes* to the State. Any profits remaining after paying taxes are at the disposal of the enterprise. On the other hand, the State will no longer provide subsidies to those enterprises that "produce" losses with independent accounting systems outside the national budget.[15]

Where taxes are not levied upon State enterprises, the introduction of a financial self-responsibility system creates complicated problems which must be solved first. In a planned economy the profit or loss of an enterprise is determined by 2 factors. Those making a higher profit because of subjective or internal factors, such as good economic management, should be rewarded, while those making more profit on account of objective or external factors not influenced by, say, enterprise management, should, in principle, turn over the profits to the State.

Those objective factors are the outcome of the following prevailing circumstances in China's planned economy:
- the price fixing system;
- the nature of the country's natural resources;
- the productivity of fixed assets and of laborers.[16]

1. The price fixing system

As indicated above, the socialization of the means of production in China and the use of economic planning have replaced the price mechanism and the profit motive as instruments to equalize supply and demand on both consumer goods and capital goods. Where a price mechanism does not exist, prices of products have to be fixed by the planning authorities. It is generally accepted that, with respect to the relationship between tax and price in a planned economy, taxes are not price-determining. Consequently, in general, prices of individual items or commodities are independently set by the State to achieve equilibrium in commodity market. The turnover tax, for example, is only one of many factors making up the final price in the price fixing system. Although the tax affects the final price, it plays at most a secondary role in fixing the price of a particular commodity, and in many cases the tax is clearly price-determined. The tax serves as a buffer between cost price and sales price and is an important element in creating equilibrium between the general price level and the cost price for individual commodities.[17]

Price fixing of goods as a substitute for the price mechanism is conducive to making profit and taxes an accounting item set out *ex-ante* in the process of the centrally planned economy.

Because of price fixing, the prices of many products in China are not commensurate with their real economic value, an important factor in determining profit margin. Products urgently needed by the people (raw and processed materials) are too cheap, while those not in urgent need (manufactured goods) are too expensive. The present profit margins of some enterprises are not determined by good economic management but by fixed prices. Without a readjustment of prices, it will be difficult to work out a rational profit retention system.

For example, a watch costs approximately 6 to 12 yuan to make, but sells for 50 yuan, so that watch companies make a big profit. Meanwhile, 1 ton of coal costs about 14.75 yuan to produce, but sells for only 11 yuan, since coal is an essential consumer good and watches are a luxury. To go from a price fixing system to a market price system is a difficult task. There is no way to institute an overall price reform; raising just a few prices will spark inflation.

It is believed that the first step in reducing the gap between various enterprises' income is to use taxes to absorb the windfall profits arising from the irrational price fixing system of goods prevailing in China. If the profit margins on some goods are too wide and yet it is impossible to lower their prices, the extra profits should be turned over to the State in the form of an income regulating tax, so that all industries and trades will attain reasonable post-taxation profits under good management of the enterprise.[18]

Thus, in brief, economic change has been stifled by the Government price fixing system. Some enterprises earn more profits and other less, not because of how well they are managed and how much their workers produce, but merely because of the prices fixed for their product.[19]

2. The nature of China's natural resources

The second objective factor is natural resources. Enterprises in mining industries bring in different profits because of different natural conditions. For example, there are large differences between the resources and consequently between the profits of the Daqing and Yumen oil fields. In such case, different rates of tax (including those on resources) should be introduced to make the profit retention system effective. In fact, some oil wells produce a few tons a day while others produce hundreds or even thousands of tons a day. Since oil is scarce, the maximum production must be achieved at all costs. On the basis of such differences in productivity, the State should either levy different taxes on resources or introduce a system whereby the mining enterprises retain varying portions of the profits they earn over and above the

14. Chen Lingshu, "Take the advantages and disadvantages of the profit retention regulations put into force as the responsibility for the organizational unit", *Jingji Guanli* (Economic Management) 1981:1, 14.
15. Jin Qi, "More on economic readjustment", *Beijing Review*, 11 May 1981, 3.
16. Xue Muqiao, *A study on the problems of Chinas's socialist economy* (Beijing, December 1979), 185 ff.
17. George N. Ecklund, *Finance the Chinese Government Budget. Mainland China, 1950-1959* (Chicago, no date), 28.
18. Luo Jingfen, "The reform of price and taxation system is the important link of the reform of the economic system", *Jingji Guanli* (Economic Management) 1980:9, 27-30, particularly 29.
19. Frank Ching, "Some of Sichuan's economic experiments are spreading to other Chinese provinces", *Asian Wall Street Journal*, 2 June 1981.

assigned profit norms.[20] China is in fact contemplating introduction of a national resources tax.[21]

The different productivity of natural resources can be illustrated in the following example:[22]

Assume that there are 3 oil wells, A, B and C, having a different productivity of respectively 50, 100 and 200 metric tons of oil at a cost of 10,000 yuan. To achieve a 20% profit rate the selling price per metric ton will be respectively as follows:

Oil well A:

$\frac{10{,}000 \text{ yuan}}{50 \text{ ton}}$ plus 20% profit rate = 240 yuan

Oil well B:

$\frac{10{,}000 \text{ yuan}}{100 \text{ ton}}$ plus 20% profit rate = 120 yuan

Oil well C:

$\frac{10{,}000 \text{ yuan}}{200 \text{ ton}}$ plus 20% profit rate = 60 yuan

If the country's selling price is fixed at 240 yuan per ton, the gross receipt per well will be 12,000 yuan per year and the total gross receipt of the 3 wells, 36,000 yuan. The difference between the selling price ands the cost price for well B is 120 yuan and is turned in as land (mining) tax to the State. For well C the land (mining) tax is 180 yuan, while well A does not turn in tax due to its poorer oil endowment.

The picture which emerges from the above illustration indicates that marginal oil well A (or even oil wells making losses) can still operate at the expense of profit making enterprises if total production is considered by the authorities as necessary for the centrally planned economic development of the country. Since price fixing of many products deviates from their real economic value, it has become a major reason for the irrational amounts of profits made and amounts of tax turned in to the State.

In the economic planning structure of China, the rates of profits and taxes are fixed *ex-ante* by the planning authorities and used as a means to measure the economic achievements of an enterprise through the economic accounting system.[23] The importance of the economic accounting system in the control of enterprise operations is recognized by Chinese writers, although the effectiveness of such control depends on the availability of accurate and prompt reporting of enterprise activities.[24] In addition, since the price of the product is set by the central government, the profit is predetermined and the manufacturer of the product cannot influence profit margins, but only can estimate production.[25]

3. The productivity of fixed assets and of laborers

The third objective factor is the differences in productivity of fixed assets resulting from the use of different kinds of equipment. Such differences are created by unequal sums of State investment and not by unequal degrees of effort on the part of the workes. To solve this problem, the State may introduce a system whereby the enterprise pays a compensation for the appropriation of fixed assets. The enterprise may pay taxes or interest on those fixed assets at different rates to offset the differences in profit margins arising from the productivity of the fixed assets used. Some Chinese tax authorities consider the fixed assets tax the "selling out" of fixed assets owned by the State to financially independent enterprises. It is asserted that fixed capital assets were redeemed ("bought out") in 1956 from their former private owners during the period of socialization of the ownership of the means of production whereas at present the tax policy would be directed to the opposite, namely, the "selling out" of fixed assets or means of production to independent account units in a planned economy of which the means of production remain in the ownership of the people, i.e. the State.[26]

The fixed assets and working capital of State enterprises have been given at no cost by the financial authorities. The enterprises have to turn over all their profits, if any, to the State and its products are purchased and marketed by the State commercial departments. Given no power or responsibility over either material supply or funds, the enterprise does not concern itself with the question of waste. Mere supervision from the higher authorities cannot be ensured by control through the economic accounting system if the persons running the enterprises are not interested. To change all this, it is necessary to make an enterprise economically responsible for the use of state funds and give it more financial power to handle its profits. It should be provided with a business fund for developing technical innovation. Part of the extra profit earned through improved personal management may be used for the worker's collective welfare or distributed as bonuses among workers who have made greater contributions to earning more profit.[27]

The rate of the fixed assets tax in 5 State-owned enterprises in Sichuan Province, applying the self-sustained profit and loss system in a trial experiment, was differentiated and may vary from either 0.2%, or from 0.3 to 0.5% or from 0.5 to 0.8% of the fixed assets value payable monthly.[28]

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20. See note 16, p. 187.
21. See note 1, Hongde et al.
22. Xiao Shuoji, "The role of average rate of profit in the socialist economy", *Jingji Yanjiu* (Economic Research) 1979:11, 74.
23. For a technical treatise on economic planning in China, see: *Chinese economic planning, translations from* Jihua Jingli *(Economic Planning)*, edited and with an introduction by Nicholas R. Lardy. Translation by K.K. Fung (1978).
24. Kwang Chingwen, "The economic accounting system of State enterprises in mainland China", *International Journal of Accounting* 2 (Spring 1976).
25. Cf. Frank Ching, "Troubled steel complex in China now operates relatively normally", *Asian Wall Street Journal*, 27 December 1980.
26. Zhang Biwei, "The problems on the levy of fixed assets tax from State-run industrial enterprises. Hunan Province Metallurgic Bureau", *Jingji Guanli* (Economic Management) 1980:5, 15-17.
27. Liu Zhicheng, "A view how to cope with the expansion of financial responsibility of State enterprises", *Jingji Guanli* (Economic Management) 1980:4, 16-90, 30.
28. Gu Zongcheng, "Problems concerning the self-sustained profit and loss system of the State-owned enterprise – Tentative study on the experimental self-sustained profit and loss system of the five enterprises in Sichuan Province", *Jingji Guanli* (Economic Management), 1980:12, 26.

Objections were raised by enterprises to basing the tax on fixed assets on the original value. Certain factories have old and obsolete fixed assets which should have been written off long ago; the authorities concerned do not agree to this and the assets are still listed in the account books at their original value. In many factories most of the fixed assets were acquired in the 1950s. After 20 years or more, practically all the depreciation costs have been written off, yet their value remains intact according to the books. It is obvious that taxation on such a nominal value would be unjustifiable.

The depreciation of fixed assets in China must be changed. Experiments undertaken in Sichuan province in enterprises acquiring greater independence in their economic management suggested a gradual shortening of the depreciation period of fixed assets and a steady increase in the funds for their replacement and for technical improvement. Under the present system the depreciation period ranges from 25 to 40 years. In the next 5 years, it should be shortened to 10 to 15 years and the annual rate of depreciation should gradually be raised from 6.5 to 10%, while 80% of the basic depreciation fund should be placed in the hands of the enterprise.[29] Thus, as some enterprises get more fixed assets, and more modern ones, from the State, they achieve higher productivity and profit. If the tax on fixed assets is not used, the profit retention system cannot be implemented on a fair and equitable basis. To introduce a tax on fixed assets, China has to conduct a nation-wide appraisal of the fixed assets of State-owned enterprises.

This is an enormous job which cannot be accomplished in a short period. Thus a reform in the economic set-up requires the readjustment in a wide field of issues in such areas as production, pricing, supply marketing and taxation. It is necessary to establish a system to transfer surplus fixed assets of one enterprise to another which is in need of such fixed asset. The enterprise having a surplus of fixed assets may transfer those assets to the higher authorities on a lease, or sell those assets to other enterprises and use the proceeds to buy whatever fixed assets it needs. Fixed assets from State investments may be placed at the disposal of banks, which will rent them to the enterprises which need to use the fixed asset. On the other hand, these fixed assets represent an enterprise liability to the State, for which the enterprise should pay an interest or fixed assets tax at regular intervals according to State regulations. At present, the State has allocated fixed assets to enterprises for use without any compensation, as "everybody eats from the same rice bowl".

It is also necessary to make changes in the labor force now operating under the "iron rice bowl" principle. At present, the State allocates manpower to enterprises without much regard for the ability of the person assigned. The State should introduce a system of vocational assessment and promotion in order to transfer to suitable jobs those who cannot fully use their abilities. An enterprise must have the power to fire those employees who prove to be incompetent in the course of employment. The discharged workers may be referred back to the labor departments for new assignments or they may also be allowed to find jobs by themselves.[30]

III. THE TAX EXPERIMENT

The State Council approved on 2 September 1980 the Report of the Economic Commission concerning the gradual expansion of the self-responsibility of State-owned industrial enterprises dated 9 August 1980.[31] As far as taxation is concerned, this Report revealed that beginning with 1981 the principle of retained profit of enterprises must be further developed and extended to provinces and prefectures on a trial basis. The experiment of self-responsibility for profit or loss of State-owned enterprises must be further developed and evolve into a tax system for China. It has been revealed that in Sichuan province 3 kinds of taxes are levied on enterprises to wit, the industrial and commercial tax, the tax on fixed assets and the income tax. In Shanghai, 5 kinds of taxes and 2 kinds of duties are levied on enterprises, viz., the industrial and commercial tax, the income regulating taxes, the tax on houses and land, the boats and vehicle license tax, the income tax and the duty on fixed assets and the duty on the use of circulating funds (working capital). The Head of the General Tax Office of the Ministry of Finance must further replace the profit retention system of enterprises by implementing tax laws concerning the taxation of enterprises in China, such as the value-added tax, the natural resources tax, the differential levies of income regulating taxes, the income tax and the duties on fixed assets and on the use of circulating funds.

The experiment "Take Tax Instead of Profit and Self-Responsibility for One's Own Profit and Loss" was applied in pilot enterprises situated in Beijing municipality, Sichuan province and Shanxi province.[32]

The Report on the Arrangement for the National Economic Plans for 1980 and 1981 revealed that a value-added tax will be introduced for machinery and farm machinery industries to solve the problem of double taxation levied on some industrial products. The income tax on urban collectively-owned enterprises will be revised so as to reduce their tax burden to facilitate the development of the collective economy in China. On an experimental basis more State-owned enterprises will have to pay income tax instead of turning their profits over to the State under the profit retention system.

Beginning in 1981, duties on fixed assets shall be levied on a trial basis on State-owned enterprises so as to promote the rational use of State capital assets allocated by the State. State-owned enterprises that use circulating funds allocated by the State will be subject to the duty on the use of circulating funds.

With respect to the capital construction sector, investment by the State will be replaced by bank loans whever repayment is possible.[33]

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29. Ren Tao, Sun Huaiyang and Liu Jinglin, "Investigation report: Enterprises in Sichuan Province acquire greater independence", *Social Science in China* 1980:1, 201, 214.
30. See note 16, pp. 188, 190.
31. Published in the *Official Gazette* of 20 November 1980.
32. See note 12, particularly pages 22-23.
33. See: *Official Gazette*... of 28 October 1980, pp. 332, 344; Wang Bingqian, "Minister of Finance at the Fifth National People's Congress on August 30, 1980. Report of financial work", *Beijing Review*, 29 September 1980, 11-

1. Tax experiments on State-run industrial enterprises in Shanghai

a. The industrial and commercial tax

The tax regulations of pilot enterprises are promulgated on a case-by-case basis. For example, one of the Shanghai diesel engine factory plants[34] is taxed in conformity with the "five taxes and two duties" approved by the State Council concerning the gradual expansion of the self-responsibility of State-owned industrial enterprises (see above). The Shanghai diesel engine factory plant comprises 32 factories employing about 9,000 laborers.

The industrial and commercial tax experiment envisages the levying of a kind of value-added tax. For China a sophisticated value-added tax system was considered necessary, which implied that for each pilot enterprise the regulation is used on a case-by-case basis. Because of the different circumstances of each enterprise, a uniform value-added tax system is not fair for socialist competition in a period of change in the set-up of the national economy.[35]

In the Shanghai experiment the consumption type of value-added tax was applied. From the total sales proceeds, the enterprise deducts a specific number of materials purchased from other enterprises and processed or used in the manufacture of the product. The difference is the value added by the entrprise by its own activity, which is the tax base for the value-added tax.

With respect to the computation of the value-added tax, the amount payable under the Shanghai consumption type of value-added tax is obtained by the subtraction method rather than the tax credit method.[36]

The deduction of purchases by the enterprise from sales proceeds consists of 7 specified materials obtained from other enterprises and processed in its product. The processed materials comprise raw materials, auxiliary materials, fuels, purchased spare parts, repaired spare parts, low cost materials and package materials. The formula used to calculate the value added tax is the following:

The amount of the industrial and commercial tax is the sales proceeds multiplied by the value-added ratio multiplied by the applicable rate of the industrial and commercial tax.

The formula of the value-added ratio is:

$$\text{Value-added ratio} = 1 - \frac{\text{Production cost} \times \dfrac{\text{processed purchased materials}}{\text{purchased production expenses}}}{\text{Sales proceeds}}$$

The value-added ratio is calculated for each year per enterprise. The average value-added ratio for the year 1979 which applied to the Shanghai diesel engine factory was 54.2%. For the Shanghai factory the applicable rate of the industrial and commercial tax was 5%. The existing rates of tax were: for agricultural diesel engines, 6%, and for non-agricultural diesel engines, 10%.

The industrial and commercial tax is levied twice a month. Late payment of the tax is penalized by a fine amounting to 0.1% per day levied on the tax not paid.[37]

b. The income regulating tax

The income regulating tax levied in 1979 on the pilot Shanghai diesel engine factory was imposed at the rate of 7.5% on the "determined" profit. The rate of the income regulating tax will not be changed for 5 years if no changes take place in the fixed prices of goods, the tax rates, the costs and utilization of the factory's capacity.

If in those factors a change of 1% occurs in a certain year, the following first half year the income regulating tax rate may be adjusted by 0.4% for each 1% change. The income regulating tax is levied twice a month. Late payments of the tax are penalized by a fine amounting to 0.1% per day levied on the tax not paid. Income regulating tax is paid together with the industrial and commercial tax.

c. The income tax

At present, 270 State-run enterprises pay income tax in Shanghai, Liuzhou (Guangzi province), Sichuan and Hubei provinces.

Hubei province levies progressive income tax at rates divided into 5 income tax brackets ranging from a low of 50% to a high of 75%.

Sichuan province levies progressive income tax rates divided into 6 income tax brackets ranging from a low of 40% to a high of 78%.

Shanghai and Liuzhou both levy a proportional income tax at 50%.[38] The income tax levied on the Shanghai diesel engine factory plant was 50% on the total annual sales proceeds after deduction of the industrial and commercial tax, the income regulating tax and the production cost. The allocation to the workers welfare fund is 11% of the total annual wages paid.

The income tax is levied twice a month. Late payment of the tax is penalized by a fine amounting to 0.5% per day levied on the tax not paid.

d. Special funds

The retained profits shall be divided and transferred to the following special funds of the Shanghai factory plant:
- Production development fund: 41%;
- Staff and workers' welfare fund: 32%;
- Staff and workers' reward fund: 27%.

23, particularly 20 ("Reform of the taxation system"). See also: Yao Yilin, "Vice-Premier of the State Council delivered report at the Third Session of the Fifth National People's Congress on August 30, 1980. Report on the arrangements for the National Economic Plans for 1980 and 1981", *Beijing Review*, 22 September 1980, 30-43, particularly 42.

34. See Tao Youzhi and Huang Laiji, "The experimental conditions of self-sustained profit and loss system of the Shanghai diesel engine factory plant", *Jingji Guanli* (Economic Management) 1981:1, 16-19.

35. Han Shaochu, "Theoretical discussion on the value-added tax to be put in force. Ministry of Finance. General Tax Affairs Bureau", *Jingji Guanli* (Economic Management) 1980:1, 15-18.

36. For other types and methods of computation of value added tax, see: Carl Shoup, *Public Finance* (Chicago, 1979), 250 ff.

37. See note 34.

38. Wang Wending and Han Shaozhu, "Discussion of the problems arising from the imposition of income tax on State-run enterprises", *Jingji Guanli* (Economic Management) 1981:5, 42 ff.

Under the original profit retention system adopted, the ratios were 38, 36 and 26% respectively.

e. Tax on land and buildings

With respect to the experiment of the Shanghai diesel engine factory plant, the tax on buildings was levied at 1.2% on the annual rental value. The land tax amounts to 0.72 yuan per square metre per year with respect to land located in the city and 0.36 yuan per square metre per year for land located in the suburbs.

The tax on buildings is levied twice a year, on 20 April and 20 October. Late payment of the tax is penalized by a fine amounting to 0.5% per day levied on the tax not paid. The Shanghai diesel engine factory paid an annual tax on buildings amounting to 1,070,000 yuan. The license tax for the use of vehicles and boats paid by the Shanghai diesel engine factory amounted to 22,000 yuan per year.

f. Duties for the use of fixed assets and of circulating capital

In the experiment of the Shanghai diesel engine factory plant, 2 kinds of duties were levied.

The duty for the use of fixed assets at 0.8% per month was levied on the value of fixed assets supplied by the State at the disposal of the factory. The duty for the use of circulating capital (working capital or loan) was levied at the rate of 0.42% per month on the amount of the loan. Both duties must be paid on the 25th of each month. Late payments of duties are penalized by a fine amounting to 0.1% per day levied on the duty not paid. The Shanghai factory paid each month 586,000 yuan with respect to the duty for the use of fixed assets and 136,000 yuan with respect to the duty for the use of circulating capital.

2. Tax experiments on State-run retail trade enterprises in Tianjin

In 1979 experiments were undertaken in Tianjin by State-tun retail trade enterprises with respect to self-responsibility for one's own profit or loss. There were 20 pilot enterprises involved utilizing 3 different measures of economc self-responsibility. Ten enterprises experimented with taxation under self-responsibility for one's own profit or loss and 6 enterprises experimented with the profit retention system, whereas the remaining 4 were "responsible for a task until its completion".[39]

Self-responsibility for one's own profits or loss was subdivided in two kinds of methods, to wit, the "Five Taxes, One Duty" and the "Proportional Income Tax".

Under the "Five Taxes, One duty" method, general trade stores and groceries had to pay the following taxes: the industrial and commercial tax levied at the rate of 3% on the sales proceeds, the tax on buildings levied at the rate of 1.2% on the annual rental value, and the land tax amounting to 0.72 yuan per square metre per year. The income tax was levied at 4% of the profits, increased by a local surcharge of 15%, thus totalling 4.6%.

The duty on the use of working capital was 0.21% per month of the working capital amount. The ratio between retained profit and State share was 30 and 70% respectively. The 4 taxes and one duty are levied on the State share. The balance, if any is available, is taxed by an income regulating tax which is levied at the rate of 0.6% of sales proceeds with respect to groceries, and 2.3% with respect to department stores.

Under the "Proportional Income Tax" method, the district street general trade stores may retain 42% of the profit and transfer 58% of the profit to the State. This ratio is fixed for 3 years. From the retained profit under both methods mentioned above, different amounts were allocated to the special funds, to wit, the development funds, the welfare funds and the reward funds respectively. The ratio to the special funds differs depending on the trade branch.

For trade stores the ratio of the funds were 50, 30 and 20 respectively. For groceries 35, 25 and 40 respectively and for district street trade stores 40, 20 and 40 respectively.[40]

IV. CONCLUSION AND SUMMARY

The tax system of China, in order to be effective as part of its new economic development policy, must be tailored carefully to the path that China has chosen, the road to socialism.

It is generally conceived that the economic set-up at present no longer suits the goal of achieving high sustained economic growth after 30 years of socialist economic planning. In addition, it is strongly asserted that the present economic set-up in China must be adjusted, restructured and consolidated in order to serve better the Four Modernizations and to foster cooperation with foreign investors from countries having an economic system different than that prevailing in China. State enterprises are subject to the profit allotment system in which enterprises have to transfer all their profits to the State and, by the same token, all losses are automatically covered by State subsidies, a phenomenon which is known as "everybody eats from the same rice bowl". This was considered for a long time one of "the advantages of socialism".

The system of overall State responsibility in production and distribution of goods provides little material incentive for greater efficiency and productivity in the production and distribution of goods. To put more vitality therein, China will phase out the profit allotment system and replace it by one of self-responsibility of State enterprises for their respective profits and losses. Instead of handing over their profits to the State, the enterprises pay taxes to the State. Any profits remaining after paying taxes are at the disposal of the enterprises. On the other hand, the State will no longer provide subsidies to those enterprises which have losses.

39. "Enterprises responsible for a task until its completion and with limited profits should enlarge its right too – The Economic Commission of Mianyang Prefecture of Sichuan Province", *Jingji Guanli* (Economic Management) 1981:6, 27 ff.

40. Zheng Ning and Wang Shiquan, "The experiments effecting sole responsibility for one's own profits or losses in Tianjin's State-run retail trade enterprises", *Jingji Yangjiu* (Economic Research) 1981:6, 27 ff.

Where taxes are not levied, their introduction creates complicated problems which must first be solved. This can be accomplished by gradually expanding trial experiments in taxation of enterprises to acquaint people with the "virtues" of financial self-responsibility in doing business and paying taxes to the State instead of by one reform law promulgated overnight designed to break the "iron rice bowl" in a predominantly planned economy.

Appendix A:

CHINA'S TAX REVENUE STATISTICS

The classification of tax revenue in China has been simplified and unified to concur with the unification of the national economy in the form of public ownership of the means of production. This is reflectd in the fact that China did not provide a breakdown in tax revenue figures; consequently there seemed to be no need to follow a classification by types of taxes.

In 1959 China had disclosed some information on its economic performance in the first 10 years of its existence in the publication *Ten Great Years of Financial Accomplishments in the People's Republic of China*. This is up to now the only statistical book published by the People's Republic of China. *Ten Great Years* also contained some national tax revenue statistics. Those tax statistics do not provide a detailed breakdown of the kinds of taxes collected. Only the ratios of taxes, profits from state-owned enterprises and other items of revenue to total national revenue are given.

The purpose of China's tax statistics is to reflect the progress of the accomplishment of the national centrally planned economy. See for the developments of revenue receipts between taxes and revenue from state-owned enterprises: Tables I, II and III. The revenue structure is set out in Table IV.

The statistics on state revenue in Tables I and II are from *Ten Great Years*. The statistics in Tables III and IV on revenue development and revenue structure are from the Chinese-source publication *New China's Research Tax Department,* published in the Japanese article "Chugokuno Sozeiseido" (China's Tax System) in *Kakkokuno Sozeiseido* (Every Country's Tax System) (Tokyo, Zaikei Shohosha, 1976).

Tables III and IV supplement the figures given in Tables I and II. The revenue development statistics reveal that China from 1950 to 1960 relied more on revenue from state-owned enterprises as profit allotments rather than on taxes and much less on loans. Whereas taxes amounted to 75.1% of total revenue receipt in 1950, they amounted to only 34.8% in 1960. On the other hand, revenue from state-owned enterprises increased from 13.4% in 1950 to 64.7% in 1960. Other revenue items dropped from 11.5% in 1950 to 0.5% in 1960.

The relatively heavy reliance on revenue from state-owned enterprises may be explained by the fact that much of the peasants' income in China was in kind and the monetary tax base was, therefore, limited.[1]

In the budget statement by the Minister of Finance submitted to the plenary session of the National People's Congress held in June 1979, some revenue figures were disclosed for the first time since the publication of *Ten Great Years*. The total national revenue for 1979 was estimated at 112,000 million Yuan (112,111 million Yuan for 1978 and 87,450 million Yuan for 1977).[2] The drastically reduced state revenue estimated for 1979 in comparison to 1978 was the result of special measures taken in the new economic programm to raise the living standard in rural areas in comparison to that of urban areas. Among the measures were reduction and exemption from taxes in rural areas.[3]

No detailed breakdown of revenue receipts was given in the 1979 budget statement. The only breakdown for 1978 given was the following: taxes from industrial and commercial enterprises – 45,100 million Yuan (12.6% higher than 1977); and profit from state-owned enterprises – 44,000 million Yuan (an increase of 35%).[4]

TABLE I
State revenue
(in million Yuan)

	Total	*Taxes*	*Revenue from state-owned enterprises*	*Credit and insurance*	*Others*
1950	6,520	4,900	870	330	420
1951	12,960	8,110	3,050	570	1,230
1952	17,560	9,770	5,730	190	1,870
1953	21,760	11,970	7,670	490	1,630
1954	26,230	12,220	9,960	1,790	1,260
1955	27,200	12,750	11,190	2,360	900
1956	28,740	14,090	13,430	720	500
1957	31,020	15,490	14,420	700	410
1958	41,860	18,730	22,020	800	310

TABLE II
State revenue
(in percentage of total)

	Taxes	*Revenue from state-owned enterprises*	*Credit and insurance*	*Others*
1950	75.1	13.4	5.0	6.5
1971	62.6	23.5	4.4	9.5
1952	55.6	32.6	1.1	10.7
1953	55.0	35.2	2.3	7.5
1954	50.4	38.0	6.8	4.8
1955	46.9	41.1	8.7	3.3
1956	49.0	47.7	2.5	1.8
1957	49.9	46.5	2.3	1.3
1958	44.8	52.6	1.9	0.7

Source: Ten Great Years, Statistics of the Economic and Cultural Achievements of the People's Republic of China. Compiled by the State Statistical Bureau (Peking, 1959) (English edition).

1. Jan S. Prybyla, *The political economy of Communist China* (Scranton 1970), 204.
2. "Report on the Final State Accounts for 1978 and the Draft State Budget for 1979 by the Minister of Finance, Zhang Jingfu", *Beijing Review*, 20 July 1979, 17-24.
3. "Tax reduction in rural areas", *Beijing Review*, 16 March 1979, 12.
4. "Report on the Final State Accounts for 1978 and the Draft State Budget for 1979", *Beijing Review*, 20 July 1979, 18.

TABLE III
Revenue development
(in million Yuan)

	Taxes	Revenue from state-owned enterprises	Others
1950	4,900 (75.1%)	870 (13.4%)	750 (11.5%)
1953	11,970 (55.0%)	7,670 (35.2%)	2,120 (9.8%)
1956	14,090 (49.0%)	13,430 (46.7%)	1,220 (4.3%)
1959	20,470 (37.8%)	33,360 (61.6%)	330 (0.6%)
1960	24,360 (34.8%)	45,300 (64.7%)	360 (0.5%)

TABLE IV
Revenue structure
(in million Yuan)

	Industrial and commercial taxes	Agricultural tax	Customs duties and salt tax
1950	2,360 (48.3%)	1,910 (38.9%)	630 (12.8%)
1953	8,250 (68.9%)	2,710 (22.6%)	1,010 (8.5%)
1956	10,100 (71.7%)	2,970 (21.0%)	1,030 (7.3%)
1959	15,700 (76.7%)	3,300 (16.1%)	1,470 (7.2%)
1960	19,450 (79.9%)	3,300 (13.5%)	1,610 (6.6%)

Source: New China's Research Tax Department, published in a Japanese article "Chugokuno Sozeiseido" (China's Tax System). In: *Kakkokuno Sozeiseido* (Every Country's Tax System) (Tokyo, Zaikei Shohosha, 1976).

Appendix B:

FOREIGN ENTERPRISE INCOME TAX LAW

(Adopted at the fourth session of the 5th National People's Congress on 13 December, promulgated by an order of Ye Jianying, Chairman of the NPC standing committee, the same day, entered into force on 1 January 1982)

The Income Tax Law of the People's Republic of China Concerning Foreign Enterprises

Article 1. Income tax shall be levied in accordance with this law on the income derived from production, business and other sources by any foreign enterprise operating in the People's Republic of China.

"Foreign enterprises" mentioned in this law refer, with the exception of those for whom separate provisions are stipulated in Article 11, to foreign companies, enterprises and other economic organizations which have establishments in the People's Republic of China engaged in independent business operation or cooperative production or joint business operation with Chinese enterprises.

Article 2. The taxable income of a foreign enterprise shall be the net income in a tax year after deduction of costs, expenses and losses in that year.

Article 3. Income tax on foreign enterprises shall be assessed at progressive rates for the parts in excess of a specific amount of taxable income. The tax rates are as follows:

Range of income	*Tax rate (%)*
Annual income below 250,000 yuan	20
That part of annual income from 250,000 to 500,000 yuan	25
That part of annual income from 500,000 to 750,000 yuan	30
That part of annual income from 750,000 to 1,000,000 yuan	35
That part of annual income above 1,000,000 yuan	40

Article 4. In addition to the income tax levied on foreign enterprises in accordance with the provisions of the preceding article, a local income tax of 10% of the same taxable income shall be levied.

Where a foreign enterprise needs reduction in or exemption from local income tax on account of its small-scaled production or business, or low-profit rate, this shall be decided by the people's government of the province, municipality or autonomous region in which that enterprise is located.

Article 5. A foreign enterprise scheduled to operate for a period of 10 years or more in farming, forestry, animal husbandry or other low-profit occupations may, upon approval by the tax authorities of an application filed by the enterprise, be exempted from income tax in the first profit-making year and allowed a 50% reduction in the second and third years.

With the approval of the Ministry of Finance, a 15-30% reduction in income tax may be allowed for a period of 10 years following the expiration of the term for exemptions and reductions mentioned in the preceding paragraph.

Article 6. Losses incurred by a foreign enterprise in a tax year may be carried over to the next year and made up with a matching amount drawn from that year's income. Should the income in the subsequent tax year be insufficient to make up for the said losses, the balance may be made up with further deductions against income year by year over a period not exceeding five years.

Article 7. Income tax on foreign enterprises shall be levied on an annual basis and paid in quarterly instalments. Such provisional payments shall be made within 15 days after the end of each quarter. The final settlement shall be made within 5 months after the end of a tax year. Excess payments shall be refunded by the tax authorities or deficiencies made good by the taxpayer.

Article 8. Foreign enterprises shall file their provisional income tax returns with the local tax authorities within the period prescribed for provisional payments. The taxpayer shall file its final annual income tax return together with its final accounts within 4 months after the end of the tax year.

Article 9. The method of financial management and the system of accounting of foreign enterprises shall be submitted to local tax authorities for reference.

Where the method of financial management and the system of accounting of foreign enterprises is in contradiction with the provisions of the tax law, tax payments shall be assessed according to the provisions of the tax law.

Article 10. Foreign enterprises shall present relevant certificates to the local tax authorities for tax registration when they go into operation or close down in accordance with law.

Article 11. A 20% income tax shall be levied on the income obtained from dividends, interest, rentals, royalties and other sources in China by foreign companies, enterprises and other economic organizations which have no establishments in China. Such tax shall be withheld by the paying unit in each of its payments.

For the payment of income tax according to the provisions in the preceding paragraph, the foreign companies, enterprises and other economic organizations which earn the income shall be the taxpayer, and the paying unit shall be the withholding agent. Taxes withheld on each payment by a withholding agent shall, within 5 days, be turned over to the state treasury and the income tax return submitted to the tax authorities.

Income from interest on loans given to the Chinese government or China's state banks by international finance organizations shall be exempted from income tax. Income from interest on loans given at a preferential interest rate by foreign banks to China's state banks shall also be exempted from income tax.

Income derived from interest on deposits of foreign banks in China's state banks and on loans given at a normal interest rate by foreign banks to China's state banks shall be taxed. However, exemption from income tax shall be granted to those foreign banks accordingly in whose countries income from interest on deposits and loans of China's state banks is exempted from income tax.

Article 12. The tax authorities have the right to investigate the financial affairs, account books and tax situation of any foreign enterprise, and have the right to investigate the withholding situation of any withholding agent. Such foreign enterprise and withholding agent must make reports on facts and provide all relevant information and shall not refuse to co-operate or conceal any facts.

Article 13. Income tax levied on foreign enterprises shall be computed in terms of renminbi (RMB). Income in foreign currency shall be assessed according to the exchange rate quoted by the State General Administration of Exchange Control of the People's Republic of China and taxed in renminbi.

Article 14. Foreign enterprises and withholding agents must pay their tax within the prescribed time limit. In case of failure to pay within the prescribed time limit, the appropriate tax authorities, in addition to setting a new time limit for tax payment, shall surcharge overdue payments at one half of 1% of the overdue tax for every day in arrears, starting from the first day of default.

Article 15. The tax authorities may, acting at their discretion, impose a penalty on any foreign enterprise which has violated the provisions of Articles 8, 9, 10 and 12 of this law.

In dealing with those withholding agents who have violated the provisions of Article 11 of this law, the tax authorities may, in addition to setting a new time limit for the payment of the part of tax that should have been withheld and, at their discretion, impose a penalty of not more than the amount that should have been withheld.

In dealing with foreign enterprises which have evaded or refused to pay income tax, the tax authorities may, in addition to pursuing the tax, impose a fine of not more than five times the amount of tax underpaid or not paid, according to how serious the offence is. Cases of gross violation shall be handled by the local people's courts according to law.

Article 16. In case of disputes with tax authorities about tax payment, foreign enterprises must pay tax according to the relevant regulations first before applying to higher tax authorities for reconsideration. If they do not accept the decisions made after such reconsideration, they can bring the matter before the local people's courts.

Article 17. Where agreements on tax payment have been concluded between the government of the People's Republic of China and the government of another country, matters concerning tax payment shall be handled in accordance with the provisions of these agreements.

Article 18. Detailed rules and regulations for the implementation of this law shall be formulated by the Ministry of Finance of the People's Republic of China.

Article 19. This law shall come into force as of 1 January 1982.

IFA NEWS

GREEK BRANCH

The following review written by Mr. Alun G. Davies, honorary president of IFA, has been submitted by the General Secretariat of IFA.

A Greek Economist's Journal,
by Professor Athanase John Sbarounis

Professor Athanase Sbarounis was the President of the XVIth Congress of the International Fiscal Association at Athens in September 1962, and continues to this day to be Chairman of the Greek Branch of IFA, which he has ably led for many years. It was during the Athens Congress that he introduced Dr. Mitchell Carroll, then President of IFA, for the presentation to Dr. Carroll of the Silver medal of the City of Athens. In the course of his address to the participants in the Athens Congress, the mayor of the City of Athens, Dr. Angelos Tsoukalas, recalled that Dr. Carroll's father had been a professor of Greek, and his mother a professor of Greek archaeol-

[Continued on page 83]

MALAYSIA:

1982 PROPOSALS

This survey was prepared by *SGV Taxation Services SDN. BHD.*, Kuala Lumpur, Malaysia.

I. INTRODUCTION

The Minister of Finance in his 1982 Budget Speech presented to Parliament on 23 October 1981 made several amendments and additions to the country's tax legislation. The proposals will become law when they receive the Royal Assent or when the relevant Orders/Rules are gazetted. Points 1 to 18 hereinafter are therefore subject to the aforesaid events.

II. 1982 BUDGET – SUMMARY OF DIRECT TAX AMENDMENTS

Income Tax Act, 1967

Banks – Special loan scheme

2% income tax rebate to banks amended with the intention of including over-drafts.

Shipping companies

- New 12-year exemption period introduced.
- Tax-exempt dividend limit increased to 15%.
- Relevant periods of 4 years each concept introduced re tax exemption consequent upon compliance with conditions.
- 50% abatement of chargeable income for the 12 years after the tax holiday period.

Insurance companies

Income tax rate on profits from insurance of offshore risks lowered to 5%.

Late payment of tax

Penalty of 1% per month for 5 months replaced by a 5% penalty upon expiration of 60 days from date of first penalty of 10%.

Interest to non-residents

Interest paid by banks licensed under the Banking Act, 1973 are exempted from withholding tax.

Accelerated depreciation allowance

Qualifying period extended to 31 December 1985 and to all industries.

Tax-exempt interest income

- Savings account interest:
  - Bank Simpanan Nasional – no limit.
  - Bank Pertanian, Tabung Haji and Malaysia Building Society – interest on deposits up to $10,000 only.
  - Licenced banks and finance companies – interest on deposits up to $1,000 only.
- Time deposits – no limit on amount if deposits are for more than 12 months.

Tax-exempt dividend

Dividends from investment in Amanah Saham Nasional and other approved unit trusts up to $5,000 per annum.

Insurance premiums on imports

Double deduction allowed if insurance is taken out with an insurance company which is incorporated in Malaysia.

Wages of the handicapped

Employer who employs a disabled person is entitled for double deduction of the wages paid.

Real Property Gains Tax Act, 1976

Compulsory acquisition of land

Gains derived from compulsory acquisition will with effect from 23 October 1981 be exempt.

Inter-spouse land transfers

Tax-free transfers permitted between husbands and wives.

Deemed market value transactions

Extended to include those transactions between unconnected persons.

Transfers on reorganisation, reconstruction or in compliance with NEP amalgamation

- Condition on type of consideration removed.
- When assets are distributed by liquidator, no tax arises.

Sale of assets in the seventh years

Gains on assets sold in seventh year of ownership and thereafter, NIL tax rate.

Investment Incentives Act, 1968

Hotel incentives

- Abatement of chargeable income extended to 31 December 1986 for hotels of approved standard built and opened for business in Kuala Lumpur and Penang.
- Pioneer status and hotel accelerated depreciation allowance for hotels of approved standard built and opened for business in Kuala Lumpur and Penang extended to 31 December 1986.
- New incentive for all hotels of approved standard called Hotel Tax Credit (similar to investment tax credit) introduced.

General

Road transportation fees

Revised as follows:

		Rate *Current*	Rate *Proposed*
1.	the first registration fee for a motor vehicle other than an invalid carriage, a motor bicycle or a motor tricycle	$30	$60
2.	fee on the transfer of a motor vehicle other than an invalid carriage, a motor bicycle or motor tricycle	$20	$40
3.	fee for international driving licence	$30	$60
4.	fee for the issue of a duplicate license	$ 5	$20

Travellers and overseas visitors

New exemptions as follows:

1. Travellers to be exempted from import duty, surtax and sales tax on the following items:

(a) tobacco not exceeding 225 grams (equivalent to 200 cigarettes);
(b) matches not exceeding 100 sticks;
(c) cosmetics, perfumery, soap and dentifrices, in open containers to a total value not exceeding $200;
(d) wearing apparel not exceeding 3 pieces;
(e) footwear not exceeding 1 pair;
(f) electrically and battery operated portable appliances for personal care and hygiene not exceeding 1 unit each;
(g) dutiable foot preparations to a total value not exceeding $75;
(h) souvenirs and gifts to a value not exceeding $200.

For a visitor to enjoy the exemption, he must be in Malaysia for at least 72 hours while for a Malaysian returning from abroad he must be away for the same period. In addition, the articles must be the property of the visitor or the Malaysian and for his personal use.

2. A flat duty of 60% to be imposed on all dutiable items except motor vehicles, liquor and cigarettes brought in by travellers.

Abolition of excise duty and reduction of import duty

Categories of goods:

1. Electric lamps;
2. Electric rice-cookers;
3. Gas stoves;
4. Electric iron;
5. Electric kettle;
6. Oven;
7. Toothpaste;
8. Soap, washing preparations and scouring powder;
9. Cement;
10. Gramophone records;
11. Fans;
12. Mattresses.

III. AMENDMENTS TO THE INCOME TAX ACT, 1967

1. Tax rebate on loans to small business (Section 61B)

With effect from the year of assessment 1981, income tax chargeable on a lender who grants a qualifying loan to a small business is rebated by 2% per annum on the outstanding balance of the loan "calculated on a term loan basis".

It is proposed that the words "calculated on a term loan basis" be deleted from the year of assessment 1982 with the intention that the rebate would also be granted in respect of qualifying overdrafts.

(With effect from year of assessment 1982).

2. Shipping companies – tax exemption (Section 54A)

A 12-year exemption from tax for shipping companies was introduced from the year of assessment 1979.

The Bill proposes to create a replacement tax exemption period in that income tax relief will be given for all Malaysian shipping companies for a period of 24 years commencing from the year of assessment 1982 or date of incorporation, whichever is the later. The companies are required to meet two conditions:

(a) they cannot declare more than 15% dividend which will be tax exempt in the hands of shareholders;
(b) they must use at least 75% of the fleet acquisition reserve for the purchase of ships on the following basis:
   (i) for the first 12 years under this scheme, full exemption will be given if the 75% utilisation condition is fulfilled as at the end of every 4 years of operation, failing which they are then allowed to satisfy the 75% condition at the end of the 12th year.
   (ii) for the next 12 years, companies will be examined every 4 years for compliance of the 75% fleet acquisition reserve condition and the limitation of dividend to 15% tax exempt. If such conditions are fulfilled, the companies will be allowed an abatement of 50% of their chargeable income from tax.

Briefly the above changes mean that whereas a shipping company has previously to incur, by the end of its last basis period for the tax exempt period, capital expenditure to the extent of 75% of fleet acquisition reserve account balance on the acquisition of ships or vessels in order to qualify for tax exemption, it is proposed that with effect from the year of assessment 1982 the 12-year tax-exempt period be divided into "relevant periods", each comprising 4 consecutive basis periods. Under the proposal the 75% requirement would be applied at the end of each relevant period. If a company fails to meet the 75% investment requirement at the end of any relevant period, tax exemption would not apply to that period unless at the end of the 12th year the 75% requirement is met with overall.

For the purposes of this incentive, the Bill provides that capital expenditure is deemed to have been incurred:
- when expenditure is made;
- on the signing of a contract for the purchase of a ship or vessel;
- when a similar commitment is undertaken and it is proved to the satisfaction of the Director Gefneral that such commitment is for the actual purchase of a ship or vessel.

(With effect from year of assessment 1982).

3. Shipping companies – abatement of chargeable income (new Section 54B)

It is proposed that from the year of assessment 1982, a Malaysian resident shipping company should have its chargeable income in respect of transporting passengers or cargo by sea abated by 50% for 12 years commencing from the year of assessment immediately following its tax exemption period described above under Section 54A.

Any chargeable income thus abated should be credited to an exempt account. Dividends paid out of the balance on this account would be tax exempt in the hands of shareholders. If a corporate shareholder is involved, dividends paid by that shareholder out of the exempt dividends received would be tax free to the shareholders of said company.

Similar restrictions as to the payment of dividends (15% limit) apply as described above.

As in the case of tax-exempt shipping companies, any excess of the audited net profit less actual tax payable and dividend paid should be credited to a fleet acquisition reserve which may only be reduced by capital expenditure incurred on the acquisition of ships and vessels.

The 75% investment requirement, relevant period concept, withdrawal of the tax exemption for any relevant period and definition of "incur" apply to the abatement provisions as they do to the exemption provisions.

(With effect from year of assessment 1982).

4. Insurance companies (Section 60)

The proposed new Section 60(2) provides that life, inward reinsurance, offshore insurance and general insurance business would all be treated as separate businesses.

Offshore insurance is defined as insurance of a risk under a general policy where the risk is outside Malaysia and the policy of insurance is issued by an insurer resident in Malaysia or a branch in Malaysia of a non-resident insurer. Where any risk is in transit in Malaysia, it shall be deemed to be outside Malaysia.

It is proposed that the adjusted income of the newly created class of separate business, the offshore insurance business, should be computed in the same way as the adjusted income of the general insurance business is computed both for resident as well as non-resident insurers, as the case may be.

(With effect from year of assessment 1982).

5. Offshore insurance – incentives (New Section 60B)

The new proposed Section 60B is a replica of the provisions of Section 60A except that it provides an incentive for the offshore insurance business and not the inward reinsurance business.

The Bill seeks to reduce the income tax rate on the chargeable income from inward reinsurance from 40% to 5% from the year of assessment 1982. As in the case of the inward reinsurance business the chargeable income less tax is available for franking tax-free dividends.

The existing Section 60B should, it is proposed, be renumbered Section 60C.

(With effect from year of assessment 1982).

6. Penalties on late payment of tax (Section 103(5A))

Under existing legislation, a 10% penalty may be imposed if tax is not paid by the due date(s). Further this percentage may be increased to 15% by additions of 1% for each subsequent period of 30 days during which tax charged under a notice of assessment remains outstanding.

The Bill seeks to replace the 1% per month penalty with a 5% penalty chargeable upon the expiration of 60 days from the date of the first penalty of 10%.

The proposed amendment would assist the Inland Revenue in its administrative functions.

(With effect from year of assessment 1982).

7. Tax-exempt interest (Schedule 6 Paragraph 33)

The anticipated revisions to the above paragraph would from the year of assessment 1982 enable licensed banks to pay or credit interest to any non-resident, including the overseas branch of a non-resident bank, without deduction of withholding tax. Such interest would not be subject to Malaysian tax unless it accrues to a place of business of that non-resident in Malaysia.

(With effect from year of assessment 1982).

IV. AMENDMENTS TO THE REAL PROPERTY GAINS TAX ACT, 1976

8. Compulsory acquisition of land under law (New Paragraph 3(f) Schedule 2)

The Bill seeks to provide that gains on disposals on or after 23 October 1981 arising from compulsory acquisitions of land under the Land Acquisition Act, 1960 are not subject to tax under the Act as the disposal price would be deemed to be equal to acquisition price.

(With effect from 23 October 1981).

9. Transfer of chargeable assets between spouses (paragraph 3(b) Schedule 2)

Under the proposed amendment, any transfer of chargeable assets between husbands and wives from 23 October 1981 would be tax free as the disposal price would be deemed to be equal to the acquisition price. (Nevertheless, for the purpose of the private residence exemption, only one life-time exemption will continue to be available to both husbands and wives as any private residence owned by the wife would, for the purposes of this exemption, be deemed to be owned by her husband.)

(With effect from 23 October 1981).

10. Transactions deemed to be at market value (New Paragraph 9(e) Schedule 2)

The Bill seeks to specifically provide that from 23 October 1981, in cases where the anti-tax avoidance provisions of Section 25(2) apply, e.g. where there is evasion or avoidance of tax, the acquisition and disposal of the chargeable assets in question shall be deemed to be at market value.

(With effect from 23 October 1981).

11. Intra-group transfers and transfers upon reorganisations, etc. (Paragraph 17(1)(b) Schedule 2)

Sub-paragraph 17(1)(b), which was subjected to a major alteration in 1977, would, if the proposed amendment is passed, be again changed.

At present, in order that exemption from tax could be claimed, where a chargeable asset is transferred under a scheme of reorganisation, reconstruction or amalgamation, consideration receivable should be in the form of shares or substantially in the form of shares and the balance in cash. The amendment does not place any restrictions on the form of consideration receivable and a wholly cash consideration is now possible.

Further, the amendment provides that where a chargeable asset is distributed in specie by a liquidator under a scheme of reorganisation, reconstruction or amalgamation, no taxable gain or loss arises.

The usual conditions that the transferee company must be a Malaysian resident company and the scheme must be in accordance with the New Economic Policy on capital participation in industry must be met in order to qualify for exemption.

It should be noted that the condition that the consideration should be in the form of shares, or substantially in the form of shares and the balance a money payment, would continue to apply to intra-group transfers for the promotion of greater efficiency in operation under Paragraph 17(1)(a).

(With effect from 23 October 1981).

12. Rate of tax (Schedule 5)

A new tax band has been created under the Bill. Assets sold after the 6th anniversary of the date of acquisition will no longer be subject to tax as the relevant rate of tax would be reduced from 5% to 0% in respect of disposals made on or after 23 October 1981.

Non-citizens and non-permanent residents of Malaysia would however continue to be taxed at 40% on assets acquired after 17 October 1980 irrespective of the period of ownership. However, if the assets were acquired by the non-citizens or non-permanent residents prior to 17 October 1980, then gains on such disposals would be entitled to the graduated rates of tax or the exemption depending on the holding period.

V. OTHER AMENDMENTS BASED ON THE 1982 BUDGET SPEECH

13. Accelerated depreciation allowance (ADA)

Under the existing 1980 Rules, qualifying plant expenditure incurred from 1 January 1978 to 31 December 1982 on the provision of machinery or plant used directly in the manufacture of any product or subjection of goods to any process would qualify for capital allowances of 100% in the year in which the expenditure was incurred.

The Minister of Finance has proposed that ADA should be granted to all industries (apparently in its widest possible sense), including the leasing industry, on qualifying plant expenditure incurred in the period to 31 December 1985.

An Order to this effect should be made in due course and it is expected that companies enjoying pioneer status, etc. would continue to be excluded from claiming ADA.

14. Tax exemption on interest income

The current exemption available on interest on savings accounts with the Bank Simpanan Nasional is that on a deposit of $30,000 for a calendar year. It is proposed that this limit be removed from the year of assessment 1982 such that all savings account interest from the Bank Simpanan Nasional would be tax exempt.

Interest on savings deposits of up to $10,000 placed by individuals with registered cooperatives, Bank Pertanian, Tabung Haji, or the Malaysia Building Society would remain exempted from tax as at present.

However, in the case of interest from licensed banks and finance companies, interest on savings deposits of up to $1,000 only would be tax exempt from the year of assessment 1982. The current exemption level is interest on $10,000.

It is proposed that the limit placed on interest on fixed deposits exceeding 12 months currently stated at deposits of $10,000 be removed from the year of assessment 1982 such that all interest on deposits exceeding 12 months with approved institutions, e.g. licensed banks and finance companies, would be tax free. Although there are no fixed deposits of 12 months plus one day, it appears possible to claim tax exemption in respect of interest on 15-month fixed deposits prematurely terminated after 12 months.

Whilst for the year of assessment 1981 the exemption applied to individuals as well as companies, it would appear from the Minister's speech that the new exemption Order when issued would restrict the exemption to individuals only from the year of assessment 1982.

15. Double deduction on insurance premiums

With a view to encouraging the insurance of imported goods with locally incorporated companies, it is proposed that any importer who incurs premiums in respect of the insurance of goods imported into this country would from the year of assessment 1982 qualify for a double deduction on the expense if the insurance is taken out with a Malaysian incorporated insurer.

Clients may therefore consider changing the basis of purchasing goods to exclude the CIF basis, where relevant.

16. Double deduction for wages of handicapped employees

As an incentive for the employment of the handicapped, it is proposed that from the year of assessment 1982, the wage expense of employing the disabled should qualify for a double deduction.

17. Incentives to hotels

The abatement of chargeable income provision is an incentive offered to the hotel industry. Under this incentive, chargeable income is abated by between 15% to 30%, depending on the location of the hotel, for 12 years of assessment. In respect of Kuala Lumpur and Penang, this incentive expired on 31 December 1973. In view of an anticipated shortage of hotels in these areas, it is proposed that the incentive be extended to hotels completed or modernised by 31 December 1986.

Further, it is proposed that pioneer status and accelerated hotel depreciation allowance be extended to all hotels of an approved standard in Kuala Lumpur and Penang which are completed/modernised and opened for business from 1 January 1974 to 31 December 1986.

A new incentive hotel tax credit which is similar to investment tax credit is to be introduced for all areas. In respect of Kuala Lumpur and Penang, this incentive will be available up to 31 December 1986. It is expected that under hotel tax credit, companies will be able to claim a minimum credit of 25% calculated by reference to capital expenditure incurred on the hotel building and plant, machinery and apparatus used in the hotel business in the period of 5 years from the beginning of the financial year in which the hotel project was approved for hotel tax credit purposes. The actual credit percentage granted could be much higher than 25%. Relief is claimed through a reduction of the adjusted income of the company by utilising the credit granted. As the credit may be utilised at any time, this incentive would be expecially beneficial if the company does not expect to realise profits within the first few years of operation.

18. Exempt dividends from approved unit trusts

It is proposed that with effect from the year of assessment 1982, the amount of exempt dividends receivable from the Amanah Saham Nasional and other approved unit trusts be increased from $4,000 to $5,000.

VI. CHANGES IN INLAND REVENUE PRACTICES

19. Progressive profits basis of assessing housing developers

The Inland Revenue has previously accepted the completed contract basis of assessing developers. However, since 1981 there has been a move to assess developers on a progressive profits basis. The text of an individual directive by the Inland Revenue is reproduced below:

"As the definition of stock-in-trade in Section 2 of the Income Tax Act, 1967 includes work-in-progress, a company's development projects qualify for a direction under Section 36 of the Act.

Accordingly, the Director-General has directed that under Section 36 of the Act, the gross income and adjusted income from each project for the basis period for each year of assessment in the period within which each project is carried on and completed by the company shall be computed in the following manner:

$$\frac{\text{Total amounts of payment received in the basis period for the year of assessment}}{\text{Full sale consideration}} \times \text{Adjusted income finally ascertained on completion of the project}$$

Pending completion of each project for the purpose of provisional assessment, the company is required to estimate the net profit in respect of the project and the same should be allocated to the basis period for the particular year of assessment in the proportion of the total amount of payments received in that basis period to the full value of the project (consideration). The statutory income can then be arrived at after deducting therefrom the capital allowance due for the year."

"Payment received" includes booking fees and advances. A review of the position would arise following the completion of the project when any tax adjustments necessary would be made restrospectively.

MALAYSIA:

BUDGET 1982

Extracts from the Budget Speech 1982 pronounced on 23 October 1982 by Mr. Mulia Tengku Razaleigh Hamzah, Minister of Finance.

A detailed discussion of the Malaysian tax system appears in the Publication: Taxes and Investment in Asia and the Pacific

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Export duty exemption for processed palm oil

It is very encouraging to note the rapid growth which has taken place in the palm oil refining industry in the last few years as a result of the tax incentive provided by the Government in the form of exemption from the export duty on processed palm oil products. While this incentive has been effective in promoting downstream processing of palm oil, it is necessary to make some changes to the duty exemption structure in order to take account of higher costs of refining and to encourage a wider variety of export products. It is therefore proposed that:

(i) the basic level of exemption will be increased from about $75 to $95 to take account of higher cost of refining;

(ii) processed palm oil products will now be classified into 5 categories instead of 4 categories as at present. There will be a new category III to take account of a product which has undergone three stages of processing and which should therefore be given more duty exemption;

(iii) the rates of exemption will be adjusted, so that there is a difference of 5 percentage points between each of the categories. In effect, this will mean that the exemption rates for category II in the present structure will be reduced by 5 percentage points, with no change in the other categories. Thus, the present policy which emphasises the export of a variety of refined palm oil products will be maintained.

To be consistent with this policy, the export duty on stearin which is now at a flat rate of 5% will also be changed. Thus, from now on, fully refined stearin will not be subject to the export duty. The 5% export duty will only apply to crude and semi-refined stearin.

The new changes will give, on the average, an additional gain of about $20 per ton to the manufacturers of palm oil products.

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Hotel Incentives

To further encourage tourism, the hotel incentives for Kuala Lumpur and Penang island, which expired at the end of 1973, will be further extended up to 31st December, 1986 for hotels of approved standard.

In addition to the existing incentives, namely full tax relief under pioneer status conditions and abatement of chargeable income, the Government will also introduce a new incentive in the form of Hotel Tax Credit to be provided in all areas.

In the case of Kuala Lumpur and Penang island, this incentive is available only up to 31st December, 1986. This tax incentive will be similar to the Investment Tax Credit which is being provided for the manufacturing sector i.e. a minimum tax credit of 25% of the total capiutal expenditure incurred on the project.

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Real Property Gains Tax Act

The Real Property Gains Tax Act will be amended to exclude gains arising from the transfer of a house between a husband and a wife from the tax. A transfer between a husband and a wife is an internal dealing within the same household, and therefore should not attract tax under the Act.

The provision under the Real Property Gains Tax Act to exempt gains arising from restructuring of companies to conform with the New Economic Policy is found to be restrictive. The Act requires that the companies carry out the transactions in shares or substantially in shares and the balance in cash.

This requirement may deter foreign companies to restructure as they may not want to hold shares in the locally incorporated companies and minority shareholders may prefer cash.

Therefore, the Act should be amended to allow exemption even if the transaction consists of money payment rather than in shares provided that the transfer is made under an approved scheme of reconstruction. Distribution of assets by the liquidation of a company will also not be taxed if it is done under an approved scheme of reconstruction.

Another change is to exclude from tax the gains arising from the disposal of an asset which is compulsorily acquired by the Government.

Finally, it is also proposed that from to-day any gain derived from the sale of assets in the 7th year onwards after their acquisition and thereafter will not be subject to tax. At present, tax is imposed at 5% on the gain from the disposal of an asset in the 7th year of acquisition onwards.

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Double deduction

We remember our Ex-Servicemen, especially those who have been incapacitated in the line of duty. It is also important to maximise the utilisation of our manpower resources. Thus, to encourage the employment of the handicapped, and in keeping with the compassionate spirit of the Year of the Handicapped, I propose that double deduction will be provided for wages incurred in employing handicapped persons. All equipment and appliances for the specific use of the handicapped will also be exempted from customs duty. The surtax and sales tax will be abolished for wheelchairs, artificial arms, artificial legs, calippers, hearing aids, buggy invalid chairs and dialysis machines.

Apart from expanding public expenditure, the private sector, will also be encouraged to maintain a high rate of growth in investment and production. At present, Accelerated Depreciation Allowance (ADA) is provided up to basis year 1982.

However, because it has proved beneficial to industries, and has helped to promote industrialisation and modernisation, the period for the ADA will be extended up to basis year 1985. Its scope will now be widened to include not only the manufacturing sector, but to all industries including leasing.

It is expected that this new extension will contribute significantly to greater investment and economic growth as the ADA allows 100% of the capital expenditure to be written off in one year.

The granting of Investment Tax Credit will be geared to provide more tax benefits in order to expedite the development of heavy and ancillary industries.

Thus, while the minimum rate of tax credit granted under this incentive is 25% of total capital expenditure incurred in the project, priority industries will be granted higher rates in order to give them greater relief from tax.

An important incentive available to industries in the manufacturing sector is the exemption from import duties, surtax and sales tax on their imports of raw materials and machinery.

I propose to streamline the administration of duty exemptions so as to make it expeditious and more widely available to the manufacturing sector. Thus:

(a) The surtax on imports of a wide range of raw materials which are not available locally and for which there is only a surtax of 5% will be abolished. Instead, the reduced rate of surtax at 2% or 3% as the case may be, which is payable under the existing exemption system, will be integrated into the import duty. The advantage of this proposal to manufacturers is that they can now obtain the reduced duty of 2% or 3% for importing their raw materials without having to apply for it;

(b) As a further incentive, those industries which import the raw materials bearing the 2% or 3% rate of import duty, can apply for exemption from this duty if such industries comply with the New Economic Policy in terms of equity participation, management and employment structure upon certification by the Foreign Investment Committee;

(c) Furthermore, the surtax and sales tax on imports of machinery and equipment which are not produced locally and which are directly used in manufacturing, will now be totally abolished.

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Shipping

In order to help expand our shipping industry and reduce the foreign exchange paid to foreign shipping, the 1979 tax incentive for the shipping industry will be replaced by a new incentive scheme to make it more attractive for Malaysian ship-owners.

It is proposed now that income tax relief be given to all Malaysian companies for a period of 24 years commencing from the year of assessment 1982 or date of incorporation, whichever is the later. The companies are required to meet two conditions namely:

(a) they cannot declare more than 15% dividend which will be tax exempt in the hands of the shareholders; and

(b) they must use at least 75% of the fleet acquisition reserve for the purchase of ships.

For the first 12 years such companies will be eligible for full tax relief. In the next 12 years, these companies are eligible for a 50% abatement of chargeable income.

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Insurance

Another important area where foreign exchange can be conserved is in insurance. As Malaysia develops, the service sector of the economy and the Balance of Payments must also expand.

Thus the preferential tax treatment provided in the 1980 Budget for inward reinsurance will be extended to insurance companies covering offshore risks as a further encouragement for them to break into the international insurance market.

Therefore, the tax rate applicable to profits earned by Malaysian incorporated companies on the coverage of offshore risks will be reduced from the normal company rate of 40% to 5%.

Malaysian importers will also be further encouraged to insure with Malaysian insurance companies. For this purpose, it is proposed to provide an incentive in the form of double deduction from income tax on the insurance expenses for the cargo.

SRI LANKA: BUDGET 1982

Extracts from the Budget Speech for 1982 pronounced on 23 October 1981 by Mr. Ronnie de Mel, the Minister of Finance and Planning.

See for a detailed discussion of Sri Lanka's tax system the Bureau's publication: Taxes and Investment in Asia and the Pacific

A. Direct taxes

1. Surcharge on Income tax and Wealth tax

Mr. Speaker, in the country's present difficult financial situation, at a time when the ordinary man is called upon to bear considerable burdens due to the rise in the cost of living, I feel that the more affluent sections of the population should make a greater contribution to government revenue. We must remember that we cannot continue to balance the budget on the backs of the poor. I therefore, propose to impose a surcharge both on income tax and on wealth tax. The surcharge on income tax will be different from the surcharges which have been levied in the past. The surcharge will be on a progressive rate schedule and only the more affluent taxpayers will be called upon to pay it. The surcharge will not be levied on companies and individuals whose taxable income does not exceed Rs.25,000. The surcharge will be levied on income tax and wealth tax payable for the year of assessment 1981-82 as follows:

(a) Income tax:

(i) Companies, bodies of persons, etc. –
Where the taxable income exceeds Rs.25,000 and does not exceed Rs.50,000 – 5% of the income tax payable;
Where the taxable income exceeds Rs.50,000 – 10% of the income tax payable.

(ii) Individuals –
Where the taxable income exceeds Rs.25,000 and does not exceed Rs.50,000 – 5% of the income tax payable;
Where the taxable income exceeds Rs.50,000 and does not exceed Rs.200,000 – 10% of the income tax payable;
Where the taxable income exceeds Rs.200,000 – 15% of the income tax payable.

(b) Wealth tax:
A surcharge of 10% on the Wealth Tax payable.

These surcharges will bring in additional revenue of Rs.200 million.

2. Tax incentives

Mr. Speaker, there has been a drop in the revenue collected from direct taxes in recent years. One of the main reasons for this drop is the provision of numerous tax holidays as incentives for investment. While there was justification for those incentives in the early stages of our new economic policies, I am of the view that tax holidays should not be a permanent feature of our tax system because of their revenue and equity implications. I, therefore, propose to have a cut-off date for approvals for tax holidays and to fix this date as 31st March 1983. Approvals granted up to this date will hold good only if meaningful steps are taken within one year from the date of approval. Mr. Speaker, this proposal would have the effect of inducing entrepreneurs to take positive steps, within the next year or two, to embark on new ventures. This would further accelerate the development programme of the country. The removal of the tax holiday would not apply to export-oriented enterprises licensed by the GCEC.

3. Exemption of profits arising to foreign contractors

There is provision under Section 22 of the Inland Revenue Act for the exemption from income tax of the profits accruing to foreign contractors, under certain specified circumstances. Mr. Speaker, there is no justification for continuing to exempt such profits. This provision was introduced at a time when Sri Lanka did not provide an attractive climate for investment and when there were only a few Double Tax Relief Agreements.

Exemption under this section is now not granted to a contractor who is a resident of a country with which there is a Double Tax Relief Agreement. The reason is that, where there is such an agreement, Sri Lanka tax paid is allowed as a credit against the tax payable in the contractor's home country. If exemption is granted to the foreign contractor he would not get such a tax credit and would have to pay the full tax in his home country. Sri Lanka would thus unnecessarily forgo revenue for the benefit of a foreign government.

I, therefore, propose to repeal Section 22 of the Inland Revenue Act.

4. Small company relief

Mr. Speaker, in order to encourage the small entrepreneurs to organize their businesses as limited liability companies, concessionary rates of tax have been granted to small companies. The existing provisions define a small company as one whose issued capital does not exceed Rs.500,000.

Resident companies other than quoted public companies pay tax at 50% of their taxable income, while quoted public companies pay tax at 40%.

Instances have come to light of companies earning high incomes which maintain their issued share capital at a figure of less than Rs.500,000 in order to benefit from the concessionary rates of tax. I, therefore, propose to subject small companies to the normal rate of tax of 50% on the excess of their taxable income over Rs.250,000 per annum.

A small company which is a quoted public company would, however, continue to pay tax on the present rate-schedule applicable to small companies even if its taxable income is over Rs.250,000.

5. Foreign entertainers and artistes

At present there is no provision in the Inland Revenue Act to compel an employer or a sponsor to withhold a percentage of the payments made to foreign entertainers, artistes, etc., for tax purposes. In order to prevent any loss of revenue by the non-payment of tax by these persons, I propose to make suitable amendments to the Inland Revenue Act so as to empower an employer or sponsor to withhold 33⅓% of the payments due to these categories of persons against their tax liabilities.

6. Minors' extended deposit schemes

Mr. Speaker, several banks have started deposit schemes whereby the deposits made on behalf of minors are payable with interest to the beneficiary after a period of 20 years or more. Under the present law, tax on interest has to be calculated on an accrual basis for each year of assessment. In view of the long period of maturity of these deposits, it will not be practicable for taxpayers to ascertain the interest each year and to pay tax on such interest. I, therefore, propose that –

(a) the banks should be required to deduct tax at 15% on the interest element from the amount payable on maturity or at the time of withdrawal;
(b) the tax so deducted should be deemed to be a final levy.

This mode of payment of tax would be convenient both to the taxpayer and to the banks.

7. Interest payable under the Land Reforms Act

Mr. Speaker, under the Land Reform (Amendment) Act, No. 39 of 1981, interest at 10% is payable on compensation due to the previous owners of lands taken over by the Land Reform Commission. Interest income is liable to income tax on an accrual basis. It will not be practicable, however, to make assessments from 1972-73 onwards on the additional tax payable by these owners as a result of these interest payments. I, therefore, propose that –

(a) the interest payable at the rate of 10% under the Land Reform Law should be treated as income arising in the year in which the interest is actually paid;
(b) the Land Reform Commission should be required to deduct tax at 10% from the interest payable;
(c) the tax so deducted should be deemed to be a final levy.

This will yield a net interest rate of 9% on the recipients.

8. Non-Resident Foreign Currency Accounts

Mr. Speaker, at present the interest arising on deposits in Non-Resident Foreign Currency Accounts is exempt from income tax only during the period in which the holder of the account is not resident in Sri Lanka. These deposits are, however, exempt from wealth tax both during the period in which he is non-resident and for a further period of three years after he becomes resident.

With a view to making Non-Resident Foreign Currency Accounts more attractive, I propose that, as in the case of wealth tax, the interest on these deposits should be exempt from income tax both during the period in which the holder of the account is non-resident and for a further period of three years after he becomes resident.

9. Exemption of earnings abroad

There is provision under the Inland Revenue Act to exempt the emoluments earned in foreign currency by an individual in respect of services rendered abroad if such emoluments (less reasonable personal expenses) are remitted to Sri Lanka. This provision was enacted to encourage Sri Lankans who are engaged in short-term assignments abroad to bring back their foreign exchange savings to Sri Lanka. In recent years, several resident consultancy firms have also been engaged in rendering services abroad for payment in foreign currency. Mr. Speaker, I am of the view that these resident companies and partnerships too should be granted a tax exemption similar to what is available to individuals, which would act as an incentive for them to bring back their foreign exchange earnings to Sri Lanka. I propose to make the necessary changes to the Inland Revenue Act.

B. Turnover tax and import duty

1. Turnover Tax on Imports on Manufacturing businesses

Mr. Speaker, under the existing law, Business Turnover Tax at rates ranging from 1% to 35% is levied on locally manufactured goods, whilst import duties at rates ranging from 5% to 500% are levied on imported goods. In addition, there is a turnover tax on services and a general turnover tax of 2% on non-manufacturing businesses.

The present import duty has two functions. It is partly a revenue measure and partly a protective measure to assist local industries.

It is desirable that the two elements of import duty, namely, the revenue element and the protection element, be separated. This would ensure that the revenue component of import duty at the point of import would be identical to that of the turnover tax on a locally manufactured article when sold. The balance payable at the point of import will represent the level of protection afforded to the locally produced article. The new Turnover Tax Act will enable tax to be levied on this basis.

Under the existing provision, turnover tax in respect of manufacturing businesses is levied at rates ranging from 1% to 35%.

Mr. Speaker, under the new scheme which will take effect immediately, a turnover tax will be imposed on most of the imports. This will be in addition to the present customs duty. However, where an imported item is used in the manufacture of goods or commodities in Sri Lanka, the turnover tax paid on the imported item will be deducted from the turnover tax payable by the manufacturer. Similarly, where a locally manufactured component is used in the manufacture of another item, the turnover tax paid on the component will be deducted from the tax payable by the final manufacturer. In other words, the tax levied on the manufacturer will only be on the value added. The new system will, therefore, be more equitable and will provide a certain degree of relief to the local manufacturer. To provide further relief to the local manufacturer, I propose, with the introduction of the new turnover tax on imports, to reduce the Customs duty on machinery and essential raw materials used in industry from the present level of 12.5% to 5%.

There will be only 3 basic rates of turnover tax, namely, 2%, 5% and 10%. A three-tier rate structure simplifies the administration of the tax.

The 2% rate will apply to:
Agricultural inputs;
Building materials;
Food items (other than infant milk foods which would be free of tax);
Fishing boats and fishing nets;
Handloom and pure cotton textiles;
Petroleum and petroleum products;
Pharmaceuticals (including ayurvedic preparations);
Other manufactured items which are now subject to turnover tax at 1%.

Mr. Speaker, some of these items are items of mass consumption, but I feel that there is no alternative to taxing goods which are articles of mass consumption if additional resources of the magnitude required have to be mobilized. This is the price we have to pay for development and employment.

The increase in the prices of these commodities as a result of the tax will be only marginal. For example, a 2% tax will have no real impact on the price as rice is no longer a controlled commodity. The seasonal fluctuations in the price on the free market will greatly exceed the 2% tax which will amount to only about 10 cents a measure of rice.

The 5% rate will apply to practically all the other items. However, a very few items which are at present taxed at over 5% will fall into the 10% band.

In the case of liquor and beedies, the existing rate of 15% will continue, whilst in the case of tobacco and cigarettes, the existing rate of 35% will continue.

Mr.Speaker, the existing business turnover tax law contains a host of exemptions. There is no justification for these exemptions, and I propose to remove most of them. However, undertakings for the manufacture of desiccated coconut, copra, coconut fibre, coconut oil, crepe rubber, sheet rubber, block rubber, scrap rubber or tea, as well as undertakings for the cultivation of tea, rubber and coconut, will be gazetted as exempted business.

Mr. Speaker, I also proposed to exempt the following items from turnover tax:
(a) Infant milk foods;
(b) Fertilizer;
(c) Crude oil;
(d) Articles manufactured in Sri Lanka and exported by the manufacturer (excluding jewellery and gems);
(e) Goods or materials which are imported and proved to the satisfaction of the Principal Collector of Customs to be goods or materials which would be used in the production in Sri Lanka of goods or commodities for export.

These items will be classified as "excepted articles".

The additional revenue expected from the new scheme of turnover tax is estimated at Rs.1,290 million.

2. Banks, Finance Companies and Pawnbrokers

Mr. Speaker, banks are now liable to a turnover tax of 2% on their income receipts. The banking sector has recorded a high rate of growth of 10% in 1979 and 15% in 1980. This sector has been enjoying substantial profits over the past 2-3 years which are mainly a reflection of the greater economic activity and their increased external transactions. I propose to increase the rate of turnover tax on banks from 2% to 5%.

Finance companies are now liable to BTT at 5% on their total receipts, which include capital sums as well. There is no rationale for adopting a different basis for levying turnover tax on finance companies as compared to banks, particularly as banks also engage in hire purchase business, which was earlier the preserve of finance companies. Also, finance companies, like banks, are now subject to supervision and control by the Central Bank. Accordingly, in the new Turnover Tax Act the definition of turnover as applicable to finance companies has been amended to bring it in line with that applicable to banks. However, I propose to increase the rate applicable to finance companies from 5% to 10%.

Pawnbrokers are also liable to turnover tax on their total receipts which include capital sums. I propose to adopt the same definition of turnover so that pawnbrokers will hereafter be liable to turnover tax, as in the case of banks and finance companies, only on their income receipts. I propose, however, to increase the rate of turnover tax from 2% to 5%.

The additional revenue from this proposal relating to banks, finance companies and pawnbrokers will be about Rs. 50 million.

3. Advertising

Mr. Speaker, during the past few years there has been a significant increase in advertising expenditure, and the newspapers have benefited from this increase. I, therefore, purpose to increase the rate of turnover tax on the advertising receipts of newspapers and periodicals from 5% to 10%.

The additional revenue from this source is estimated to be around Rs. 10 million.

4. Construction

Mr. Speaker, there are a number of businesses in which there has been a phenomenal increase in activity over the last two or three years as a result of the policies adopted by the present Government.

Two sectors have enjoyed particularly large increase both in their total turnover and in their profits. One such sector is the construction industry.

Mr. Speaker, it is my view that the contractors engaged in construction activities, as well as architects and consultants engaged in these activities, can well afford to pay higher rates of turnover tax.

In the case of contractors in the construction industry, the rate of turnover tax is, therefore, being increased from 2% to 3% of the total value of the contract. In the case of architects and consultants, the rate of turnover tax is being increased from the present level of 5% to 10%. The rate for the other professions will remain at 5%.

5. Hotel Sector

Mr. Speaker, the other sector which has enjoyed particularly large increases both in its total turnover and in its profits is the hotel industry. Tourist arrivals have increased rapidly in the last 3 years and hotel owners have increased their room rates sharply because of the increased demand. Room charge increases are far in excess of the amounts warranted by increased costs. The hotel owners have also been given very liberal income tax concessions so that the large profits made by them are not subject to tax periods ranging from five to ten years.

I am confident that hotels can easily pay an increased rate of turnover tax. I, therefore, propose to increase the rate of turnover tax on hotels from the present level of 15% to 20%. The new rate will be made effective from 1st April 1982 in order to give hotels sufficient notice of the change.

Representations have been made that if the higher rate of turnover tax is levied not only on hotel room charges but also on hotel restaurant charges, hotel restaurants would not be able to compete with outside restaurants. I am, therefore, increasing the turnover tax payable by restaurants which are patronized by tourists. Such restaurants are registered with the Ceylon Tourist Board and are given liquor licences on the basis of such registration.

The rate of turnover tax applicable to luxury restaurants will be increased from the present rate of 2% to 10%.

The additional revenue expected from these proposals would be approximately Rs. 25 million.

6. Import duty exemption – Government Departments

Mr. Speaker, I am of the view that the duty exemption which is at present available to government departments and to some corporations on imports made by them should be removed. The removal of the exemption would not, of course, provide the Government with any additional funds, as the duty would appear both on the receipts and expenditure sides of the Budget, but, if government departments and corporations paid normal duties, we would have a more realistic picture of government expenditure and costs of various projects. In addition, potential domestic suppliers of intermediate inputs or of final products would be given a fair chance to compete. At present, contractors for Government who import finished goods for use on contracts can import them duty free, while local suppliers who fabricate products from imported components pay duty. The reduction of duty exemptions will also simplify the administration of customs to a great extent. Finally it will prevent any leakage or avoidance of duty.

Preparations for this change will be made in 1982 and it will be brought into force from 1st January 1983.

C. Excise duties

Mr. Speaker, excise duties on liquor and the tobacco tax have been revised upwards with almost monotonous regularity with every Budget. In spite of the resulting price increases, revenue from liquor and tobacco taxes has continued to grow. After an initial dip in demand immediately following the price increase, demand once again picks up to maintain an upward trend. In view of this, I am proposing the following increases in respect of liquor, cigarettes and beedies.

1. Liquor

The increase in excise duty on liquor with effect from midnight today, will result in the following price increases:

Molasses arrack	Rs. 3 per bottle
Coconut arrack	Rs. 5 per bottle
Processed arrack	Rs. 10 per bottle
Country-made foreign liquor	Rs. 10 per bottle

In the case of imported liquor, the new turnover tax will increase the price of a bottle of whisky by approximately Rs. 30 and the price of a bottle of brandy by approximately Rs. 35 to Rs. 40.

The additional revenue expected from this proposal is around Rs. 175 million.

2. Cigarettes

Mr. Speaker, I propose to increase the tobacco tax by Rs. 41 per kilogramme, from Rs. 241 per kilogramme to Rs. 282 per kilogramme with effect from midnight today. This increase in tobacco tax will have the effect of putting up the retail prices of all brands of cigarettes by 5 cents per cigarette.

The import duty on raw tobacco will be increased by the same amount so as to equalize the duty incidence.

The additional revenue from this proposal is about Rs. 255 million.

3. Beedies

Mr. Speaker, the price differential between beedies and cigarettes has continued to widen with every Budget, when invariably the price of cigarettes was increased by an increase in the tobacco tax or in the BTT rate, with no corresponding increase in the tax on beedies.

I am, therefore, considering the imposition of an excise duty on beedies, which will bring in additional revenue of around Rs. 70 million. The necessary amendments to the Excise Ordinance to give effect to this proposal will be introduced in Parliament before the end of this year.

4. Beer

Mr. Speaker, the current excise duty on beer amounts to Rs. 12.50 per litre or approximately Rs. 9.40 per bottle of beer. The duty on beer in 1978 was Rs. 4 per litre and was increased to Rs. 6.33 per litre in January 1979 and to Rs. 8.50 per litre in February 1980. Thus, within a space of three years the duty has been pushed up by more than 300%. There is definite evidence that there has been consumer resistance to the high price of beer, which at present is retailed at around Rs. 19 per bottle exforeign liquor shops. The demand for beer, which is not a hard liquor like arrack, has been on the downward trend, mostly due to the sharp increase in prices. I propose therefore, to reduce the duty on beer. The resulting reduction in the price of beer coupled with the proposed increase in the price of arrack would help in weaning people away from the consumption of hard liquor. The excise duty reduction will also encourage the sale of local beer as against imported beer, as no corresponding reduction is being made in the import duty on imported beer.

I propose to reduce the excise duty on beer from its present level of Rs. 12.50 to Rs. 8.50 per litre, which was the level at which it stood before the last increase in November 1980. This should enable the retail price of beer to be reduced by about Rs. 3 per bottle. I expect the increase in consumption to more than offset the effect of the decrease in the rate of duty.

Revenue proposals 1981
Additional revenue

	Rs.Million
Surcharge on income tax and wealth tax	200
Restriction of small company relief	2
Turnover tax on imports and increase in manufacturers' tax	1,290
Increase in turnover tax on banks, finance companies and pawnbrokers	50
Increase in turnover tax on hotels, approved restaurants, contractors, architects and consultants	25
Increase in turnover tax on advertising receipts of newspapers and periodicals	10
Increase in excise duty and turnover tax on liquor	175
Increase in taxes on tobacco	255
Imposition of excise duty on beedies	70
Stamp fees on liquor licences	10
Increase in stamp duty on cheques	3
Revision of fees levied by government departments	15
Increase in licence, registration and transfer fees on motor vehicles	65
	2,170
Less:	
Reduction of import duty on machinery and essential raw materials	200
	1,970

Estimate of expenditure and revenue 1982

		(Rs. Million)	
(i)	Recurrent Expenditure	– 21,114	
	Less: Provision for under-expenditure	+ 450	
			– 20,664
(ii)	Advance Account Receipts		+ 100
			– 20,564
(iii)	Revenue		+ 19,319
(iv)	Current Account Deficit		– 1,245
(v)	Capital Expenditure	– 20,817	
	Less: Provisions for under-expenditure	+ 902	
			– 19,915
	Overall Deficit		– 21,160

D. Licence tax fees

Mr. Speaker, licence fees and charges for services rendered by various government departments bring in about Rs. 300 million annually to the Government. Most of these fees and charges have not been revised for a long time. I feel that these fees and charges should be revised so as to bring them in line with current costs and prices.

1. Liquor Licence Fees

Mr. Speaker, licence fees on liquor shops and beema salawas are at present collected by the Government Agents and passed on to the local authorities.

I propose that the issue of a licence should, in addition to a licence fee, be subject to a stamp fee as well. The stamp fee will vary, depending on the type of activity for which the licence is issued. Higher stamp fees will be payable in respect of licences within the municipal areas.

The additional revenue from this proposal will be about Rs. 10 million.

2. Stamp duty on cheques

I propose to increase the stamp duty on a cheque from 10 cents to 25 cents. This proposal will yield an additional revenue of Rs. 3 million.

3. Licence fees on Government Vehicles

Mr. Speaker at present there is no licence fee payable on vehicles owned by government departments. I propose that these vehicles should also be liable to licence fees. This would be in keeping with my proposal that government imports be subject to import duties.

4. Fees for Registration of Nursing Homes

Most of the nursing homes in the city as well as in provincial towns are doing well and there is no reason why they should not be called upon to contribute to government revenue. I, therefore, propose that the fee for first registration be increased from Rs. 100 to Rs. 10,000 and that the annual licence fee be increased from Rs. 50 to Rs. 2,000.

5. Other fees and charges

Mr. Speaker, there are a number of services for which fees are charged by the respective government departments under various laws and ordinances which govern the levy of such fees. I propose that the fees charged under the following heads be doubled so as to bring these fees in line with the increased costs of providing these services:

(i) Court fees;
(ii) Audit fees;
(iii) Fees of the Survey Department;
(iv) Fees under the Weights and Measures Ordinance;
(v) Fees under Merchant Shipping Act;
(vi) Fees of the Valuation Department;
(vii) Fees charged for Registration of Companies.

It is expected that the increase in these fees would bring in Rs. 15 million in additional revenue.

6. Revenue licence fees on Motor Vehicles

Mr. Speaker, a new scheme for the licensing, registration and transfer of motor vehicles – to be effective from the licensing year 1982 – will be implemented by the Registrar of Motor Vehicles shortly.

The licence fees as presently levied are based on the age and the tare of the vehicles. There are at present six categories based on the age of the vehicle and ten categories based on the tare. This complicated structure is being simplified by reducing the age categories from 6 to 2 and the tare categories from 10 to 5 for motor cars. In the case of vehicles other than motor cars there will be only 8 categories based on tare and none based on age.

The new scheme has been drawn up with the following objectives in mind:

(a) to increase the total licence fees derived from motor vehicles;
(b) to keep licence fees on very small cars below 15 cwts. in weight low, irrespective of the date of registration, to encourage the use of light cars which are fuel efficient;
(c) to substantially increase the licence fees on cars where the tare exceeds 25 cwts. so as to discourage the use of heavy cars consuming large quantities of fuel;
(d) to reduce the advantage which diesel car owners now enjoy because diesel is sold at a much lower price then petrol.

The new licence, registration and transfer fees will bring in additional revenue of about Rs. 65 million. In anticipation of this additonal revenue, a sum of Rs. 50 million has already been provided in the 1982 Estimate as additional grant to the local bodies for maintenance of roads.

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ogy, and that an ancestor of Dr. Carroll, Charles Carroll, had been a signatory of the Declaration of Independence of the U.S.A. (He did not mention the interesting fact that Dr. Mitchell Carroll had been conceived on Greek soil!)

Professor Sbarounis was Director of Direct Taxation at the Greek Ministry of Finance from 1925 to 1935, when he was appointed Director of Studies and Inspection at the Ministry. In 1936 he was appointed Director-General of Taxation (including Customs) when that post was first created. During the German Occupation of Greece he was removed from his post (in 1942) and became Economic Counsellor to the Ministry of Finance. In 1943 he escaped from Occupied Greece and was dismissed from government service by the collaborationist Greek government of Occupied Greece for abandonment of his post. On his arrival in Cairo he was again appointed Director-General of the Ministry of Finance by the Greek Government in exile, led by Tsouderos. After the liberation of Greece in 1944, Professor Sbarounis resumed his post at the Ministry of Finance. In 1944, he was also elected Professor of Public Finance at the Athens School of Economic and Commercial Sciences, which chair he held till 1962, when he was elected Emeritus Professor. During his career after World War II Professor Sbarounis was deputy-governor of the National Bank of Greece, Head of a Greek mission to the U.S.A., a Governor of the World Bank, and represented Greece on many international bodies.

While a considerable part of Professor Sbarounis's career was spent in the stormy years of World War II and the difficult reconstruction period that followed it, he carried out considerable research on taxation in the period between the two world wars. In 1934 he wrote "L'Impôt sur le revenu en Grèce", being an analysis of the three basic laws passed in 1919, on income, on real property, and on successions, as amended thereafter by more than fifty modifications. The period between 1918 and 1934 was not a particularly stable one for Greece. The World War I aftermath included the Asia Minor debacle of the Greek armies and the refugee problems which followed the abandonment of the Greek settlements in Asia Minor. The process of reconstruction in Greece, accompanied by a new law on net wealth and increasing rates of tax, led to considerable discontent amongst taxpayers, baffled by high taxes and retrospective assessments, and by continual tax reforms passed by government after government anxious to change the tax base. Professor Sbarounis analysed this turbulent development, helped by his researches into the various tax systems employed in Western Europe. He concluded that the level of taxation in Greece was excessive, both by reference to the pre-1914 rates and by reference to other tax systems in the Balkans and certain western European systems.

In 1953, before the EEC treaties had come into being, Professor Sbarounis wrote a tract on a "Project for a Turkish-Hellenic customs and economic union". It was a technical study by an economist who saw the dynamic possibilities inherent in an economic union of Greece and Turkey, neither of which had even achieved the benefits of the Industrial Revolution which had invigorated the rest of Europe, and both of which were comparatively undeveloped economies. Writing in 1966 in the "Journal de Genève", Professor Sbarounis wrote despairingly about the failure of Turkey to join with Greece in an association which would enable both countries to harness their converging interests into a profitable union, to bring them both into a prosperous and dynamic future.

One cannot help a final remark: that Professor Sbarounis has been a brave and lonely voice, crying in the wilderness for reason and logic to prevail over turgid emotions and divisive politics.

SWISS BRANCH

On 5 February 1982 a special meeting was held in Basel in which a number of subjects regarding tax harmonization in Switzerland were discussed. These subjects included:

- taxation of families;
- period of assessment;
- capital gains taxation of personal property;
- special problems connected with the taxation of legal entities (including holding and domiciliary companies).

The next regular meeting will be held on 25 June 1982 in Zurich.

NEPAL:

Budget 1981-82

Extracts from the Budget Speech pronounced on 7 July 1981 by Dr. Y.P. Pant, Minister for Finance

4.1 Honourable Chairman, now I would like to submit additional tax proposals to meet the above deficit. I have taken due care to make the present tax system more effective and efficient. Besides, special emphasis has been laid on the process of making the tax assessment procedure simple, just and practical. I have adopted the policy of increasing revenue to meet the development expenditures not so much by increasing tax rates but mainly by strengthening and improving the tax administration.

4.2 While proposing new taxes for the coming fiscal year, I have paid due attention to the principle of social justice by providing maximum relief to the low income group and small farmers. Similarly, a measure of relief has been provided for the middle income group which has faced hardship due to the rising prices. Efforts have been made to raise more taxes from the higher income group on the basis of the principle of ability to pay. The objective of any tax system is not only to collect maximum revenue but also to create a conducive environment for the production of essential commodities in the country and promote import substituting industries. It is also expected that the tax system should not adversely affect the prices of essential commodities and should facilitate expansion and diversification of international trade. On the basis of these considerations, I have designed the tax proposal for the next fiscal year.

4.3 The new Industrial Policy[1] has been promulgated with a view to accelerate industrial development in the country and also to encourage small entrepreneurs. In order to implement the policy successfully, appropriate rules and regulations will be brought out very soon. The fiscal measures, which I have proposed, aim at creating a sound, healthy and stable industrial atmosphere.

4.4 As I have already mentioned, total expenditure for the next year is higher in comparison to last year. This is necessary to meet the targets of the Sixth Plan. I have adopted the policy of generating maximum revenue from existing taxes and meeting shortfalls by the introduction of new taxes. At present, there is a very limited scope for increasing tax rates.

No significant increase of tax rates

4.5 In fact, further increases in tax rates may, at this stage, lead to evasion only. Therefore, I have specifically emphasized raising the revenue by strengthening and streamlining revenue administration as well as by bringing the potential taxpayers within the tax net. An additional amount of Rs 183.2 million is estimated to be collected from such a policy. I have submitted additional tax proposals only to cover the gap not covered by the extra proceeds resulting from the improvement in tax administration.

Indirect taxation

4.6 Now, allow me to submit indirect tax proposals.

4.7 With a view to ensure the flow of essential goods for the consumption of the common people and to check the price rise of these goods, I propose to reduce import duties on coarse cotton textile, kerosene oil and canvas shoes. Keeping in view the general health of the common people, import duty on all kinds of medicine has been reduced to 1%.

4.8 I want to assure the Honourable Members that His Majesty's Government will ever remain vigilant to ensure regular supply of such commodities and to check the rise in their prices. In this context, the price of kerosene oil has been reduced from Rs. 5.15 to Rs. 4.90 per litre by reducing its import duty, and this, I hope, will provide direct benefits to the consumers.

4.9 I have also tried to establish uniformity and consistency and narrowed the gap in the existing rates of customs duty on various commodities imported from the foreign countries.

4.10 As the Honouable Members are well aware, the year 1981 has been observed as the international year of the disabled ones. Various activities are also being organized for their welfare in Nepal. So, I have exempted fully the duties on all aids and equipment to be used by disabled persons with a view to provide necessary support to them.

4.11 Regarding the facilities provided to the newspapers and magazines, there has been duty exemption in newsprint, and 1% duty on press machines, spare parts and printing. The duty on the film used in block making has also been reduced to only 1%.

4.12 From these arrangements, revenue will decrease by Rs. 9.0 million in the next year.

4.13 However, I have proposed to increase the import duty on some luxurious items such as refrigerators, air conditioners, deepfreezes, motorcars, televisions, video-sets, cosmetic goods etc. Similarly, I have also proposed to raise import duty on woolen yarns, leather shoes as well as synthetic materials and soaps in order to protect the domestic industries.

4.14 Keeping in view the deterioration in ecological balance caused by deforestation and to meet the future domestic demand for fuel, I have raised the duty on the export of wood and allied products. Similarly, the export duty on boulder, gravels and sands has been raised with an objective of discouraging exports and precluding soil-erosion, flood and landslides.

4.15 The above mentioned adjustments in custom duties are given in Schedule No. 1, 2, 3 and 4. The revised rates will be effective from today. An additional revenue of Rs. 95.0 million is estimated to accrue from this adjustment. All other custom duties will be retained as before.

4.16 Concerning excise duties, I have proposed to change the existing duty on some of the commodities, while for some other coomodities, I have introduced new excise duty which will be effective from today.

1.	Sawn timber	Rs. 3 per cubic ft.
2.	Bidi manufactured from all types of tobacco	Rs. 6 per thousand sticks
3.	Cutlery manufactured from stainless steel scraps	Rs. 10 per kg
4.	Bricks	
	a. Made by using electric machines	Rs. 5 per thousand
	b. Made without using electric machines	Rs. 4,500 per annum per kiln
	However, the ordinary bricks made by other local methods are exempted from excise duty	
5.	Iron-rod, strips and sheets	Rs. 0.20 per kg
6.	Assembling industries which use imported spare parts	
	a. Radio and transistor sets up to the value of Rs. 600	3%
	b. Radio and transistor sets valued more than Rs. 600	5%
	c. Two or three-in-one which can be used as tape-recorders, transistors, tape-players, cassette-recorders and any set with two or more functions	15%
	d. Simple tape-recorders and cassette-players	10%
	e. Cassette-tape	
	i. playing up to 60 minutes	Rs. 0.50 per unit
	ii. playing for more than 60 minutes and continuing up to 90 minutes	Rs. 0.60 per unit
	f. All types of watches	3%
	g. Electrically operated heaters, hair-dryers, toasters, cookers, calculators run by power	2%
7.	Beer	Rs. 8.50 per litre

4.17 With a view to provide special incentives to the industries established in remote and hilly areas and to remove the existing regional disparities, I have proposed to introduce 10% rebate on prevailing excise duty to industries established in hilly areas. The mills and factories that pay excise duty on the basis of that rebate will be granted rebate of 2% for timely payment of such duty.

4.18 No excise duty will be levied on products of rural and cottage industries except soft drinks, cigarettes, bidi, catecheu, katha, alcoholic drinks, rice, oil, khandsari, sugar, sawn timber, bricks, stainless steel utensils, machine made furniture, assembling of radio transistors, watches, cassette tape recorders and players, calculators, electric heaters, hair-dryers, toasters, cookers, mixtures, juice-extractors, cassette tapes, zippers and diamond cutting.

4.19 Other adjustments made in excise duty are given in Schedule No. 5. The rest of the excise duties remain unchanged. The proposed changes will bring in Rs. 37.2 million.

4.20 As regards sales tax, three categories of sales tax rates introduced during the current fiscal year have not been changed. However, some minor changes have been made for some commodities on the basis of their use and importance. For example, rates of sales tax on cotton thread, cotton-vest, vehicle spare parts, betel-leaf, betel spices, etc. have been reduced whereas sales tax on timber, lubricating oil, motor cycles, scooters and auto-rickshaws has been increased. No sales tax is levied on products of cottage and rural industries except on those mentioned in the Schedule, This, I believe, will help encourage the rural and cottage industries resulting in increased production and employment. Such changes in rates will generate an additional revenue of Rs. 35.8 million.

4.21 The existing rate of contract tax at 2.5% on all contracts exceeding Rs. 10,000 has remained unchanged since 1965. Now, I propose to increase it to 5% of the contract amount. Such increase may be justified by changing economic conditions, growing investment and the margin of profit in contract business. This will generate an additional revenue of Rs. 26.5 million.

1. Editor's note: See for extracts of the Government's Industrial Policy Plan hereafter.

Direct taxation

4.22 Now, allow me to switch over to proposals of direct taxes. I do not have to reiterate here the economic hardship which people are facing due to inflation. Espacially, the low and fixed income groups are finding it difficult to maintain their living standard. Hence, I have proposed to raise the tax exemption limit for the next fiscal year up to Rs. 10,000 for individuals and Rs. 15,000 for couples and families. Income tax rates after the exemption limit will, however, remain intact. This will reduce revenue by Rs. 1.6 million.

4.23 On the theoretical level, it is generally agreed that individuals and commercial firms are required to keep proper accounts of their transactions. But failure on their part to maintain or submit proper accounts had led to practical difficulties in assessing taxes. Lack of proper and reliable accounts makes correct tax assessment difficult. Such a situation may give rise to the complaint among taxpayers that they have been unjustifiably overtaxed. This very situation can also lead to tax evasion. In order to encourage the habit of maintaining proper account of the transactions, from the coming year, a 2% rebate will be given to those taxpayers who get their tax assessed on the basis of accounts of their transactions. This is, however, expected to reduce revenue by Rs. 0.4 million.

4.24 That the value of urban land is increasing rapidly due to population pressure is an undisputed fact. Similarly, nobody can deny that people should at least get minimum shelter in the context of rising prices of construction materials. Keeping this in mind, I have proposed the following changes in house and land taxes from the next fiscal year. This, I believe, will give some relief to the owner cum occupier of the house while those who use their house for other purposes will have to bear additional tax burden.

Value of land & building	*Percentage of tax*
First Rs. 100,000	No tax
Next Rs. 100,000	1.0
Next Rs. 100,000	1.5
Next Rs. 100,000	2.5
Next Any Amount	3.5

4.25 But in the case of land and building occupied by the owner himself the tax on additional Rs. 100,000 will be exempted. This proposed change will generate an additional revenue of Rs. 2.1 million.

4.26 Hon'ble members are aware of the fact that the small farmers have been given a rebate of 75% on the payment of land tax. His Majesty's Government has considered to exempt fully those landowners who own up to 1.5 bighas in Terai, 20 ropanis in hilly areas and landowners who own land in those hilly areas where the cadastral survey has not been completed. Under the existing law, land revenue receipt is recognized as the legal document in case of dispute of ownership. Further, the landowners have the traditional habit of regarding revenue receipt as an evidence of ownership of land. Keeping these facts in mind and also to update land records, we have to continue to collect even a nominal amount of land revenue. From the coming fiscal year, I have, therefore, proposed a minimum rate of land revenue with 99% rebate charging only 1% of current rate, as per Schedule. This exemption limit applies to all landowners of the hilly areas where the cadastral survey has not been completed and also to those landowners who hold 1.5 bighas and 20 ropanis in Terai and hilly areas, respectively. While proposing this special rate of land tax for small farmers, due attention has also been paid to the existing denomination of small coins; and, therefore, the lowest rate of 5 paisa has been proposed for the smallest unit of land holding. This measure will definitely benefit the majority of small farmers. The loss in revenue will amount to Rs. 5.0 million.

4.27 In our country, the rate of land revenue is fixed on the basis of the type of cultivated land. The same rate of revenue is being applied to lands which are used for purposes other than agriculture. There can be no differences of opinion that the land revenue rate of residential and commercial lands should be different from that of agricultural land. In view of this, I have proposed a different rate of land tax which will be applicable in the land under town panchayat areas where the cadastral survey has been completed and the land classified under urban areas according to the provision of the Land (Survey and Measurement) Act as per Schedule from the coming fiscal year.

4.28 As the value of land of various town panchayat areas is assessed differently according to Land Survey Act, I have proposed seperate rates of land tax, as specified in the Schedule, for urban areas of Kathmandu Valley, Terai and Hills. Moreover, in these areas of town panchayats where the classification of land has not been completed, the land tax shall be collected at the lowest rate as proposed for sixth grade of land. The effect of this new proposal will yield an additional revenue of Rs. 5.0 million.

4.29 In order to keep updated land records and to discourage the practices of registering land and property in a different district other than where the land and properties exist, an additional 1% registration fee used to be charged. However, this provision could not achieve the desired objective. Therefore, I have decided to raise the above fee from 1% to 5%. This, I think, will assist greatly in maintaining updated records of land and generate an additional revenue of Rs. 3.0 million. Other rates of land revenue and registration fees will be maintained.

4.30 Hon'ble members are aware that in order to mobilise the additional resources for local development, the whole proceeds from local development tax used to be made available to the same district through Local Development Ministry. As the enthusiasm shown by the people in the current year is encouraging, I have proposed to increase local development tax to 10% of land tax. Likewise, in those districts where the cadastral survey has not been completed, a fee of Rs. 1.00 per landowner will continue to be collected. Provision has been made to deposit such proceeds in a separate account of the land revenue office. The district panchayat will directly receive such proceeds from the land revenue offices for development purposes.

4.31 Keeping in view the importance of the tourist industry as an important source of earning foreign exchange, it is necessary to encourage the tourists to prolong their stay. I propose to reduce visa fee to Rs. 75.00 for every week of the first month and to Rs. 150.00 for every week of the second month.

4.32 Besides this, all other fees and taxes remain unchanged. This proposal would yield an additional revenue of Rs. 197.5 million. Likewise, the strengthening of revenue administration and its reforms is expected to increase revenue by Rs. 183.2 milion. The net deficit would thus be Rs. 825.1 million, out of which Rs. 500,0 million and Rs. 325.1 million will be met from internal loans and cash balance respectively.

4.33 In my view the deficit financing will have no adverse impact on the economy. Because of the favourable monsoon, and our firm commitment to launch development programmes in the form of campaigns, I am fully confident that the agricultural and industrial production will increase substantially. In addition to this, all financial functions from disbursement to internal audit will be decentralized at the district level in order to strengthen financial management. Similarly, I have made special provision of funds for capital and operating capital for smooth implementation of projects. Special attempts have been made to curtail the expenditure for unproductive activities. Particular attention has also been paid to maintain strict financial discipline. Some monetary measures will be undertaken to control unproductive loans advanced by commercial banks.

4.34 While presenting the budget for the current year, I had proposed for some facilities to the Government employees to maintain their living standard and overcome difficulties arising from rising prices. Under a similar note I have made provisions for the following facilities to be provided from the coming year.

4.35 I would like to propose a pay increase of Rs. 100/- to all non-gazetted employees (including peons), Rs. 150/- to gazetted class III and II and Rs. 200/- to all those who are above them in rank. All the government employees, including civil, military and police personnel, will benefit from this provision. This arrangement will increase the basic salary of peons, section officers and the special class officers by 66.6%, 25% and 12.3%, respectively. This will incur an additional expense of Rs. 150.0 million. I would like to inform the House that this increase in pay scale is in consideration of the difficulties faced by the fixed and low income groups.

4.36 In addition, the following facilities are also provided to the employees.

4.37 Pension, which has been paid as a fixed amount so far, will henceforth match with the increase in the level of salary. As a result of this provision, after their retirement, civil servants will derive additional benefit on the basis of the salary which they will have been drawing at the time of their retirement. Gratuity has also been increased.

4.38 The maximum amount of pension has been increased to Rs. 912.50 from the existing level of Rs. 750.00. The minimum amount of pension has also been increased from Rs. 42.00 to Rs. 55.00 per month. On the demise of a pensioner, half of the pension drawn by him will be provided for his wife up to a period of ten years. It is also essential that there should be appropriate change in the rates of travel allowances. Accordingly, the daily allowances have been increased from 36% to 60% for internal travel. Daily allowance in respect of foreign travel has also been increased.

4.39 Medical facilities of the employee have been changed. Gazetted employees will henceforward get medical benefits equivalent to 12 months. Thus, the benefit of 3 extra months' salary will be available to them. Similarly, non-gazetted class I employees will get the equivalent of 18 months' salary instead of 15 months and the rest of the non-gazetted staff will get medical benefits equivalent to 21 months' salary instead of 18 months as at present.

4.40 Taking into consideration the price increase all over the world and difficulties faced by the members of our foreign missions including mission heads, foreign allowance has been increased. The allowance of low level employees of this category has been increased up to 121.73%. Similarly, the salary of the local level employee has also been increased up to 68%. Additional financial liability of about Rs. 20 million has to be incurred becuse of such provisions.

4.41 Taking into consideration the problems and difficulties faced by the government employees, arrangement has been made to constitute a pay commission to study and submit report to His Majesty's Government with respect to pay, allowances, pensions, gratuity and foreign allowances.

NEPAL:

Industrial Policy Plan 1981

Extracts of the most significant parts of the Industrial Policy Plan 1981 presented by the Nepalese Government

OUTLINES OF THE POLICY

Objectives

– To encourage private sector industrial investment as an element in the growth of gross national product.
– To open up gainful employment opportunities in the industrial sector for a labour force excessively dependent on agriculture.
– To attain self-reliance in the production and supply of essential consumer goods and most construction materials.
– To maintain regional economic balance.
– To increase the output of and attain quality improvements in currently manufactured articles.
– To improve the balance-of-payment position through increased exports and more import substitution.
– To enhance entrepreneurial, managerial and technical capabilities as a means of assisting the development of industrial organizations.
– To develop indigenous technologies and to import such appropriate technologies as will contribute to industrial productivity.

Major policies of interest to foreign investors

– All industries, except those which are defence-oriented, will be open for private sector ownership and investment.
– Existing industrial enterprises will be given incentives to improve their operational efficiency, to consolidate their position and to embark upon expansion programmes.
– The private sector will be given the first opportunity of promoting the development of industry through investment. Only if the private sector does not respond to meet the investment programme, will HMG/Nepal and agencies of government intervene by way of public investment. Even under these circumstances, HMG will pursue a policy of disinvestment in favour of the private sector as and when the climate for this appears to be appropriate.
– As a principle, HMG/N will not establish industrial enterprises under its ownership except when large scale investment is involved and private sector investment is inadequate. HMG/N will, however, take the initiative itself by financing cottage, small and medium scale pilot projects in order to stimulate private sector investment.
– Foreign investment will be encouraged in order to promote capital inflow, generate technical expertise and improve productivity. It may take the form of totally foreign owned enterprise or joint Nepalese-foreign investment. HMG/N will establish the priority areas for such foreign investment.
– Relevent technology will be imported taking account of the soci-economic situation of the country and the rate at which new methods and concepts can be absorbed. When appropriate, new techniques and processes will be identified and developed, and will not be limited to improvements on the traditionnal arts and crafts.
– Adminstrative procedures concerned with the establishment of industrial enterprises wil be simplified and made more efficient.
– Tax and other incentives will be clearly defined and specified to avoid any administrative ambiguities.
– Ownership of and investment in cottage and small industries will be reserved for Nepalese nationals only.
– Foreign investors will be permitted to have majority shareholding in medium scale enterprises. In the case of large scale enterprises, only, the foreign investment may amount to one hunderd percent.
– The principle of engaging Nepalese nationals will be followed when employing unskilled, semi-skilled and skilled labour and most other categories of employee. If circumstances demand, foreigners may be employed for a period of seven years, at the most, with the approval of HMG. The Nepalese nationals should be given appropriate training so that they can replace the foreigners within this period. If, however, specialists are not readily available within Nepal, an enterprise may continue to employ the foreigners for an additional period of five years.
– Enterprises will continue to enjoy such incentives and facilities for the period specified as are provided in the current Act without let or hindrance, notwithstanding the amendments incorporated in the present Act.
– While setting up new industrial enterprises and/or expanding, modernising and diversifying the existing ones, effective ways and means will be adopted to preventing or minimising environmental pollution.
– Industrial enterprises will not be nationalised except in special circumstances, in which case the owners will receive compensation based on a just evaluation of the net worth of the enterprises.
– Steps will be taken to establish an Export Promotion Zone with a view to the effective mobilisation of resources needed to develop and promote specified export industries.
– The mechanism relating to official guarantees for foreign loans will be institutionalised and streamlined.
– Import duty and sales tax paid against the importation of raw materials, auxiliary materials and chemicals will be reimbursed to the HMG-recognised export industries. Such reimbursement will be in proportion to the value of imported materials used in the manufacture of such exports.
– HMG will frame and enforce rules and regulations pertaining to patents, trade marks and designs.

FACILITIES AND INCENTIVES

Income tax concessions

(a) Cottage industrial enterprises, except those mentioned in Schedule 1 will be granted 100% tax exemption for a period of six years.

(b) Manufacturing industrial enterprises, smal, medium or large, will be granted income tax exemption as follows:
1. 100% exemption for 5 years if the value added is between 20% and 50%.
2. An additional one year's exemption for every 10% increase in the value added above 50%.

Value added: is defined as the ratio of net domestic annual operating costs and expenses (left after deducting all foreign costs such as imported raw materials, expatriates' salary, wages, fees, etc., depreciation of the imported assets) to the total annual operating costs and expenses.

(c) An additional 2 years' income tax exemption will be given to enterprises which produce essential consumer goods.

(d) If an enterprise exports more than 25% of its total annual production, 15% rebate will be granted on the income tax levied for that year. Similarly 25% rebate will be applicable if any enterprise exports more than 50% of its total production in one year.

(e) Energy-based and mining and mineral processing enterprises will be entitled to six years' tax holiday from the date of operation. Such industrial enterprises having more than 25% value added in each year will enjoy an additional six years' tax holiday.

(f) Five to seven years' tax holiday will be granted to new tourism enterprises, depending on the locations designated for the purpose.

(g) Service enterprises will not generally be granted tax exemption, but the following will be entitled to three years' tax holiday:
- workshops producing spare parts, tools and other end-use articles with the help of automatic or semi-automatic machinery (lathe, shaping and milling machinery);
- large warehouses;
- cold storage;
- hospitals, x-ray clinics equipped to render specialized services;
- large rental apartments;
- printing presses;
- trolley-bus and water transport services.

(h) Industrial enterprises established in the Export Promotion Zone will be granted an initial ten years' tax holiday followed by 50% rebate on income tax for the next five years.

(i) Agro-based special industrial enterprises will be exempted from income tax for a period of 10 years.

(j) Enterprises located in the areas designated as backward by HMG shall be entitled to 3 years' tax holiday in addition to those enjoyed by similar enterprises established elsewhere.

(k) The start-up date of production or providing service will be used for the purpose of computing the period of income tax exemption.

SCHEDULE 1

Industries not entitled to income tax exemption

1. Traditional rice, oil, dal (pulse), and flour mills.
2. Saw-mills
3. Bidi, cigarettes, cigars and other tobacco-based industries.
4. Distilleries and breweries producing alcoholic beverages including chhang.
5. Catechu extraction.
6. Furniture manufacture.
7. Zip fastener manufacture.
8. Enterprises producing stainless steel utensils and other articles.
9. Laundries.
10. Ice and ice cream producers.
11. Photographic services.
12. Other industrial enterprises designated, from time to time, by HMG as not entitled to income tax exemption.

(l) If an operating enterprise expands its originally licensed capacity by more than 50%, an investment allowance to an extent of 15% of the new investment will be granted and can be claimed within a maximum period of 7 years.

(m) Expenses incurred on training (recognised by the Department of Labour, HMG) with a view to providing employment for and upgrading the skills of Nepalese workers will be regarded as an item of operating expense, and such an expense will rank as a tax credit. The tax credit allowed for this purpose will be subject to a maximum of 1% of the total annual sales revenue.

Customs facilities

(a) Import duty at the rate of 1% only will be levied on (a) machinery used directly in the construction and operation of an enterprise (b) mining and related conveying equipment and (c) spare parts and tools. The entitlement of an enterprise to total exemption or a rate reduced below 1% is not affected by this clause.

(b) Import duty of 1% only will be levied on raw materials, auxiliary raw materials and chemicals to be used in the production, mixing, blending and processing. But if the duty applicable to such materials is below 1% or the enterprise is totally exempted, it will retain the preferential rights.

Notwithstanding anything mentioned in sub-clause (b) above, the raw materials, auxiliary materials and chemicals will be subject to duties currently in force if the enterprises which import them fall under the schedule designated by HMG.

(c) If these raw materials, auxiliary materials and chemicals of suitable quality are readily available within the country, an enterprise importing supplies of the same materials will pay an additional 15% customs duty.

(d) imports by industrial enterprises for their own use, by HMG, semi-government agencies, co-operatives or by the designated public limited companies will be subject to customs duties as specified in (a), (b) and (c) above. The appropriate agency of HMG will monitor the quantity of such imports and their use.

(e) Assembly enterprises which are established outside the Export Promotion Zone and whose products have more than 20% value added, will pay 25% less than the rate of duty normally applicable on the parts and components imported, provided that the imports are for their own manufacturing operations.

(f) Enterprises established in the Export Promotion Zone will be liable for only 1% import duty (a) on the machinery to be used in construction and operation (b) on spare parts and tools and (c) on raw materials, auxiliary materials, and chemicals to be used in the production, processing, mixing and blending operations. Duty paid on these items in excess of 1% will be refunded.

(g) Products manufactured in Nepal, except those designated by HMG under the relevant provisions of the current law, will not be subject to any export duty. Designated products of the kind referred to above will be promulgated after consultation with the appropriate Ministry of HMG.

(h) If manufacturers who export their products have previously paid more than 1% import duty on raw materials, auxiliary materials and chemicals, such duty paid in excess of 1% on the quantity of these materials used in the manufacture of the goods exported will be refunded.

SCHEDULE 2

Customs duties at rates currently in force, shall be levied on raw materials, auxiliary materials and chemicals imported by industrial enterprises to manufacture the following products:

1. Precious stones and jewels.
2. Stainless steel utensils.
3. Synthetic yarn and synthetic textiles.
4. Zip fasteners.
5. Acrylic yarn.
6. Photographic articles.
7. Other items notified by HMG from time to time.

(i) If the machinery, spare parts, raw materials, auxiliary materials and chemicals are supplied by domestic manufacturing enterprises to those established in the Export Promotion Zone, such supplies will be treated as exports from the viewpoint of duty concessions.

(j) In relation to tourism industry/enterprises, customs duty will be levied at 1% only, on imported items used directly, except those notified from time to time by HMG in its Gazette.

Excise duty concessions

(a) Cottage industrial enterprises will be exempt from excise duty for 5 years from the date of commencement of operations.

(b) Small, medium and large industrial enterprises will be exempt from excise duty for 3 years from the date of commencement of operations. However, no exemption will be granted to those industry categories listed under Schedule 3.

(c) Industrial enterprises established in the backward regions will be entitled to 5 years' exemption in addition to that applicable for similar enterprises located elsewhere.

(d) Manufactured goods supplied to the enterprises established in the Export Promotion Zone or exported abroad will be exempted from excise duty.

SCHEDULE 3

Industrial products not entitled to excise and sales tax exemption

1. Traditional rice mills, oil mills, flour mills, dal (pulses) mills.
2. Stainless steel products
3. Zip fasteners.
4. Precious stones and jewellery.
5. Catechu and tanin.
6. Cigarettes, bidis, cigars, chewing tobacco, snuff and other tobacco products.
7. Alcoholic beverages produced by distilleries except those distilled from fruits in the backward region.
8. Cosmetics.
9. Liquid petroleum gas.
10. Crowns, corks, etc.
11. Saw-mills.
12. Assembly industries (watch, radio, tape-recorder, cassette and calculator).
13. Acrylic yarn.
14. Other industrial products designated from time to time by HMG through notification.

(e) Excise duty will be waived totally on products manufactured in the Export Promotion Zone.

Sales tax concessions

(a) Sales tax will not be levied on the products of cottage industry.

(b) Sales tax will not be levied on imports of (a) machinery used directly in the construction and operation of an enterprise, (b) mining and related conveying equipment, (c) spare parts and tools, and (d) raw materials, auxiliary materials and chemicals.

(c) Where sales tax is already paid on the raw materials, auxiliary materials and semi-processed materials purchased, manufacturers using such materials will be exempt from sales tax on the proportion of the taxed materials used in manufacturing.

(d) Domestic products exported abroad or supplied to the enterprises within the Export Promotion Zone will have sales tax exemption to the extent of such export or supply. Sales tax exemption will not apply, however, to products listed in Schedule 3.

Concessions on electricity charges

(a) Royalties will not be charged on power generated by industrial enterprises for their own use.

(b) Royalties will be imposed on the basis of actual public sale of electric power by generating industrial enterprise.

(c) In distributing electric power from public supply mains, first priority will be given to industrial enterprises.

Concessions on interest rates

Industrial enterprises established in the backward regions shall pay interest at a rate 2% lower than others of similar status located elsewhere.

Concessions on urban property tax

Land and buildings which are essential for the operation of manufacturing and energy-based enterprises and are owned by such enterprises themselves will be exempt from urban property tax for a period of 10 years. Such exemption will be applic-

REVENUE RECEIPTS*
In millions of rupees

	During the first nine months of FY		
	1978/79	1979/80	1980/81
Tax revenue	955.4	934.6	1317.0
Customs duties	416.1	370.3	562.2
Exports	(36.8)	(40.8)	(35.3)
Imports	(351.1)	(305.3)	(485.3)
Indian excise refund	(24.9)	(23.6)	(39.9)
Miscellaneous	(3.3)	(0.6)	(1.7)
Excise	132.9	149.4	163.9
Sales tax	241.3	261.2	381.8
Income tax	51.3	38.0	51.2
Other taxes	56.2	46.9	62.9
Land revenue	21.8	27.3	44.4
Registration	35.8	41.5	50.6
Non-tax revenue	207.2	224.0	226.0
Forest	25.3	47.1	57.3
Interest and dividend	72.6	78.9	48.1
Miscellaneous	109.3	98.0	120.6
Total	1162.6	1158.6	1543.0

* *Source:* Main Economic Indicators, Nepal Rastra Bank, Research Department, Kathmandu, Nepal. Monthly Report, May 1981.

able to the following types of premises: factory building, labour and staff quarters, godowns, administrative buildings, clinics, recreation halls and canteens.

Convertible foreign exchange facility

Subject to the prior approval of HMG, convertible foreign exchange shall be provided to industrial enterprises on the basis of economic merit, for the following:

(a) The import of machinery, spare parts, tools and implements, other capital goods, raw materials, auxiliary materials and chemicals which are directly used in the industrial enterprise.

(b) Technical consultancy, technical assistance, service charges, management fees, patent fees, investment promotion, market studies, sales promotion, etc.

Protection

HMG may provide protection to industrial enterprises for a definite period, by means of quantitative restrictions on imports or by higher import tariffs if such a policy is justified on economic grounds, financial conditions, or a time requirement to improve quality and price competitiveness.

PROVISIONS RELATING TO FOREIGN INVESTMENT

– Foreign investment in industrial enterprises will be welcomed on the grounds of obtaining access to desirable technology, expansion of export markets, higher management standards and an increase in employment opportunities.
– Foreign investment will be limited to medium and large industrial enterprises. The investor may be a government, firm, individual, company or an international institution.
– An industrial enterprise financed by foreign investment must be incorporated as a limited liability company in Nepal. Foreign investment is allowed up to majority holding in the medium and 100% in the large industrial enterprises.
– If a foreign investor makes an equity investment in a Nepalese industrial enterprise, in convertible foreign currency, 100% of the dividend may be remitted in convertible currency, whether the enterprise is jointly or severally owned.
– If a foreign investor invests in shares in terms of convertible foreign currency, such shares may be sold only after an enterprise has commenced operation. Repatriation of capital will be at the rate of 20% of the sales proceeds of the shares each year up to the limit of the total investment made in convertible currency.
– If a foreign investor has invested in a Nepalese public limited company and has sold shares through the Nepalese Security Marketing Centre, the sales proceeds may be remitted in convertible currency at the maximum annual rate of 25% of the original total investment made in convertible currency.
– Managerial and technical experts who have been engaged, with the prior approval of HMG and who belong to countries where convertible currency is freely exchanged, can remit, in convertible currency, up to 75% of earnings generated by way of salary and allowances.
– Industrial enterprises with foreign equity participation will not be nationalised except in special circumstances, in which case compensation will be paid to investors on the basis of a just valuation of the net worth of the enterprise.
– If an industrial enterprise, having foreign investment, goes into liquidation, a foreign investor can repatriate his share of proceeds of sale of assets in convertible currency under the Nepal Company Act. No taxes will be levied on such amounts.
– HMG or its designated agency will stand guarantee on long-term loans under prescribed terms and conditions.
– Provision will be made through institutionalised procedures to facilitate a simple, smooth and integrated approach to foreign investment, joint ventures and arrangements for the guarantee of long-term loans. The Department of Industry will be the focal point and will be responsible as such for liaison in all these matters.

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

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Inter-American Center of Tax Administrators (C.I.A.T.): Executive Secretary of C.I.A.T., P.O. Box 215 zona 1, Panamá.

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).

Institute for International Research: 70 Warren Street, London W1P 5PA (United Kingdom).

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

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Seminar Services SA: 1 passage Perdonnes, CH-1005 Lausanne (Switzerland).

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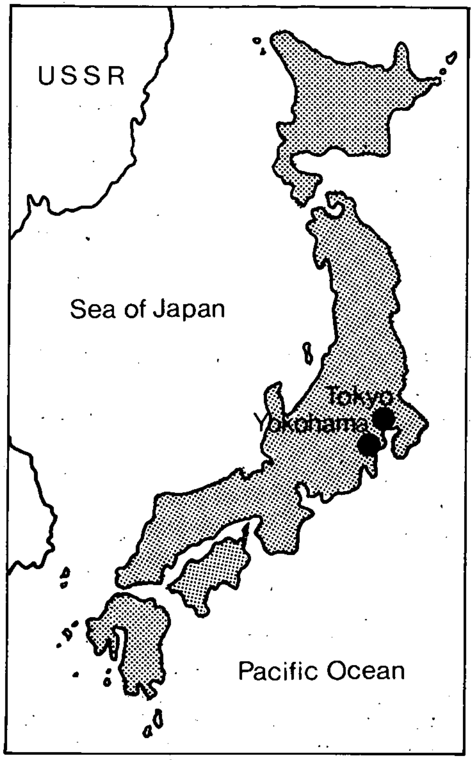
INHALTSVERZEICHNIS

SOMMAIRE

TAXING FOR DEVELOPMENT: Corporate Taxation in Japan

by Dharmendra Bhandari *



I. GENERAL

Japan has few mineral resources, has to import almost all its raw material and food, and still has the second largest economy in the non-Communist world (after the United States). Its economy grew faster than that of any other country in the world during the 1960s and its economic growth has been largely based on manufacturing exports. Economists predict that at the present rate of economic growth, Japan will overtake the United States in the next decade to be the leading economic super power.

Countries	*Real GNP growth rate* *1979*	*1980*	*1981*
Japan	5.9	5	4
United States	3.2	–0.75	0.75
West Germany	4.5	1.75	–0.25
Great Britain	1.6	–2.25	–2
OECD average	3.3	1	2

Source: (i) Based on OECD Economic Outlook No. 28, December 1980.
(ii) Figures for 1980 are expected performance while those of 1981 are future projections.

Today, Japan accounts for 10% of the world's Gross National Product, even though it has 3% of the world's population and 0.3% of the world's land (of which only 15% is arable). A comparison of the percentage increase over the previous years of the real gross national product with the industrially advanced countries of the West will illustrate Japan's outstanding economic performance.

Contents

II. INTRODUCTION

The corporate tax policy of Japan is based upon the principle of reducing the effective rate of tax through various tax deductions and exemptions to encourage economic growth.

One significant measure, which was specifically aimed at encouraging exports prior to its amendment in 1964, was the total exemption of export income from taxable income. This measure had to be terminated when Japan became a full fledged member of the International Monetary Fund by accepting Article VIII of the IMF provisions. Japanese Corporate Tax Law, while terminating the tax exemption for export income, introduced new tax measures aimed at encouraging exports by providing a wide range of relief through depreciation, reserves and incentives. (These are discussed in detail later on.)

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Article VIII
General Obligations of Members

Section 1. ***Introduction***

In addition to the obligations assumed under other articles of this Agreement, each member undertakes the obligations set out in this Article.

Section 2. ***Avoidance of restrictions on current payments***

(a) Subject to the provisions of Article VII, Section 3(b) and Article XIV, Section 2, no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions.

(b) Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member. In addition, members may, by mutual accord, cooperate in measures for the purpose of making the exchange control regulations of either member more effective, provided that such measures and regulations are consistent with this Agreement.

Section 3. ***Avoidance of discriminatory currency practices***

No member shall engage in, or permit any of its fiscal agencies referred to in Article V, Section 1 to engage in any discriminatory currency arrangements or multiple currency practices, whether within or outside margins under Article IV or prescribed by or under Schedule C, except as authorized under this Agreement or approved by the Fund. If such arrangements and practices are engaged in at the date when this Agreement enters into force, the member concerned shall consult with the Fund as to their progressive removal unless they are maintained or imposed under Article XIV, Section 2, in which case the provisions of Section 3 of that Article shall apply.

Section 4. ***Convertibility of foreign-held balances***

(a) Each member shall buy balances of its currency held by another member if the latter, in requesting the purchase, represents:
(i) that the balances to be bought have been recently acquired as a result of current transactions; or
(ii) that their conversion is needed for making payments for current transactions.

The buying member shall have the option to pay either in special drawing rights, subject to Article XIX, Section 4, or in the currency of the member making the request.

(b) The obligation in (a) above shall not apply when:
(i) the convertibility of the balances has been restricted consistently with Section 2 of this Article or Article VI, Section 3;
(ii) the balances have accumulated as a result of transactions effected before the removal by a member of restrictions maintained or imposed under Article XIV, Section 2;
(iii) the balances have been acquired contrary to the exchange regulations of the member which is asked to buy them;
(iv) the currency of the member requesting the purchase has been declared scarce under Article VII, Section 3(a); or
(v) the member requested to make the purchase is for any reason not entitled to buy currencies of other members from the Fund for its own currency.

Residential status

All corporate taxpayers are classified as either domestic or foreign corporations. A domestic corporation is a corporation having its head office in Japan. A foreign corporation is a corporation other than the domestic corporation. Thus, a corporation whose head office is registered in a country outside Japan would be a foreign corporation, even if its main place of business is located in Japan. Domestic corporations are taxed on world-wide income while foreign corporations are taxed only on Japanese-source income.

The entities subject to corporate tax are:
(i) ordinary corporations (a joint stock company, limited company, other companies, etc.);
(ii) corporations in public interest, such as incorporated associations, foundations, etc.;
(iii) cooperative associations, such as agricultural cooperative associations, small enterprises cooperative associations, etc.;
(iv) non-juridical organisations with designated representatives or managers.

III. TAXABLE INCOME

Paragraph 1 of Article 22 of the Corporation Tax Law provides that the amount of income for each accounting period of a domestic corporation is the receipts for the accounting period concerned less the expenses for the same accounting period.

Paragraph 2 of Article 22 of the Corporation Tax Law provides that the amounts to be included in the receipts for the accounting period concerned in computing the income of a domestic corporation are, unless otherwise provided, the receipts derived from sales of assets, transfer or furnishing of assets or services, whether for a consideration or not, acquisition of assets by gratuitous transfer and any other transactions other than capital transactions, etc.

Paragraph 3 of Artricle 22 of the Corporation Tax Law provides that the amounts to be included in the amount of expenses for the accounting period concerned in computing the income for each accounting period of a domestic corporation are, unless otherwise provided:
(1) cost of sales, cost of completed work and similar costs corresponding to receipts for the accounting period concerned;

Section 5. *Furnishing of information*

(a) The Fund may require members to furnish it with such information as it deems necessary for its activities, including, as the minimum necessary for the effective discharge of the Fund's duties, national data on the following matters:

(i) official holdings at home and abroad of (1) gold, (2) foreign exchange;

(ii) holdings at home and abroad by banking and financial agencies, other than official agencies, of (1) gold, (2) foreign exchange;

(iii) production of gold;

(iv) gold exports and imports according to countries of destination and origin;

(v) total exports and imports of merchandise, in terms of local currency values, according to countries of destination and origin;

(vi) international balance of payments including (1) trade in goods and services, (2) gold transactions, (3) known capital transactions, and (4) other items;

(vii) international investment position, i.e., investments within the territories of the member owned abroad and investments abroad owned by persons in its territories so far as it is possible to furnish this information;

(viii) national income;

(ix) price indices, i.e., indices of commodity prices in wholesale and retail markets and of export and import prices;

(x) buying and selling rates for foreign currencies;

(xi) exchange controls, i.e., a comprehensive statement of exchange controls in effect at the time of assuming membership in the Fund and details of subsequent changes as they occur; and

(xii) where official clearing arrangements exist, details of amounts awaiting clearance in respect of commercial and financial transactions, and of the length of time during which such arrears have been outstanding.

(b) In requesting information the Fund shall take into consideration the varying ability of members to furnish the data requested. Members shall be under no obligation to furnish information in such detail that the affairs of individuals or corporations are disclosed. Members undertake, however, to furnish the desired information in as detailed and accurate a manner as is practicable and, so far as possible, to avoid mere estimates.

(c) The Fund may arrange to obtain further information by agreement with members. It shall act as a centre fore the collection and exchange of information on monetary and financial problems, thus facilitating the preparation of studies designed to assist members in developing policies which further the purposes of the Fund.

Section 6. *Consultation between members regarding existing international agreements*

Where under this Agreement a number is authorized in the special or temporary circumstances specified in the Agreement to maintain or establish restrictions on exchange transactions, and there are other engagements between members entered into prior to this Agreement which conflict with the application of such restrictions, the parties to such engagements shall consult with one another with a view to making such mutually acceptable adjustments as may be necessary. The provisions of this Article shall be without prejudice to the operation of Article VII, Section 5.

Section 7. *Obligation to collaborate regarding policies on reserve assets*

Each member undertakes to collaborate with the Fund and with other members in order to ensure that the policies of the member with respect to reserve assets shall be consistent with the objectives of promoting better international surveillance of international liquidity and making the special drawing right the principal reserve asset in the international monetary system.

(2) selling expenses, general and administrative expenses and other expenses (excluding expenses other than depreciation expenses, liability for which is not ascertained before the end of the accounting period concerned);

(3) losses for the accounting period concerned accruing from transactions other than capital transactions, etc.

Paragraph 4 of Article 22 of the Corporation Tax Law provides that the amount of receipts for the accounting period concerned as provided for in paras. 2 and 3 must be computed in conformity with fair accounting standards.

Further, paragraph 5 of the same Article provides that the term "capital transactions, etc." as used in paras. 2 and 3 is defined as transactions increasing or decreasing the amount of stated capital, etc. of a corporation or the distribution of earnings or surplus.

Exempt income

Items excluded from gross revenue in computation of taxable income are:

(1) *Dividends received:* Where a corporation (domestic or branch of a foreign corporation) receives dividends from a domestic corporation, taxable dividends are computed by deducting from the gross dividends the interest paid by the corporation on borrowed funds, in the ratio of the average book value of the shares concerned to the average total assets.

This exemption is not available if the relevant shares were acquired within one month prior to the end of the accounting period of the distributing company and sold within 2 months after the end of the accounting period. Where the dividends received, minus interest, exceed dividends paid out by the corporation, then 25% of the excess is included in taxable income. However, this inclusion does not apply to branches of foreign companies.

If may also be mentioned that dividends received from *foreign* corporations are not exempt. However, credit for taxes is given in double taxation treaties, which Japan has concluded with other countries.

(2) *Appreciation in value:* Appreciation in value is not included in income even if a corporation increases the value of the asset in its books. However, appreciation in value is recognized as income when entered in the books at the times of corporation reorganization and also in

cases of revaluation of stock held by insurance corporations. Depreciation, however, cannot exceed the actual cost of the asset.

(3) *Tax refund:* Refunds of corporation tax, corporate inhabitant tax, etc. are not deductible as expenses.

(4) *Profit from consolidation or merger:* If a surplus accrues to an existing corporation after amalgamation or merger, the part of the surplus consisting of retained earnings of the amalgamated or merged corporation will not be included in gross income.

Non-deductible expenses

Items not deductible in computation of taxable income are:
(1) Certain taxes such as corporation tax, prefectural inhabitants tax, penalties, fines, etc.
(2) Capital expenditure which lengthens the useful life of fixed assets or increases their value.
(3) Certain amount of contributions or donations except for contributions to national or local government, or public welfare organizations, etc.
(4) Remuneration and retirement allowances of directors in excess of a reasonable amount or bonus paid to directors.
(5) Expenses not supported by vouchers, and also social and entertainment expenses in excess of the specified limit.
(6) A write-down in the value of assets except in the event of damage due to disaster or obsolescence in the case of inventories or fixed assets or substantial decline in the price of listed shares.

Deductible expenses

Normally, all necessary and reasonable expenses and costs may be deducted from gross income in order to arrive at net income.

(1) *Taxes:* Certain taxes such as excise taxes, interest tax on various national and local taxes, foreign taxes to which the foreign tax credit system is not applied for domestic corporations and enterprise taxes are deductible in computing taxable income.

(2) *Salaries, wages and pensions:* Salaries and wages paid to employees of a corporation are deductible. Pensions paid to former employees are also deductible as are retirement allowances paid to employees.

(3) *Bonuses:* Bonuses paid to employees are deductible but not if paid to directors. In the case of a person who is both a director and an employee, only that portion attributable to his status as employee is deductible.

(4) *Social insurance premiums:* Social insurance premiums, payment to employees' pension funds and similar payments by a corporation are deductible.

(5) *Entertainment expenses:* Entertainment expenses are deductible only to the extent considered reasonable by the tax authorities. Such expenses must be for the purpose of the business and supported by vouchers. Further, 90% of the excess of entertainment expenses over the fixed amounts cannot be deducted. The fixed amount is calculated as follows:

Corporations with capital of ¥ 10 million or less	¥ 4 million
Corporations with capital over ¥ 10 million but less than ¥ 50 million	¥ 3 million
Corporations with capital over ¥ 50 million	¥ 2 million

If the expenses for the current period are greater than 105% of that of the preceding period, such excess is disallowed. If it is less than that of the preceding period, however, the full amount, subject to the limit stated above, is deductible.

(6) *Contributions:* Contributions are generally not deductible except when made to
(a) national and local governments: fully deductible;
(b) public interest corporations, etc.: up to double the limit stated in (c) below;
(c) other contributions including contributions to political or religious organizations or societies: deductible up to half the total of 2.5% of profits plus 0.25% of capital.

(7) *Bad debts:* Bad debts may be deducted if:
(a) there is a reconstruction scheme, special settlement agreement or composition admission under legal procedures, etc.; or
(b) it is impossible to recover all the amount of debt because of insolvency; or
(c) business dealings have been suspended for more than a year; or
(d) the cost of collecting the debts will be more than the amount of debts.
For reserve for bad debts, see V. Reserves.

(8) *Deferred expenses:* Such expenses as are properly chargeable to capital account and recoverable by means of amortization over a period of more than one year are known as deferred expenses. Some of the significant manners of treating deferred expenses are explained below:
(a) deferred expense of less than ¥ 100,000 per item is deductible in the year in which it is incurred;
(b) the following specified deferred expenses may be expensed in the accounting period in which they are incurred:
- incorporation expenses;
- interest paid to shareholders under Section 291 of the Commercial Code before the corporation becomes profitable;
- research and development expenditures;
- expenses incurred in opening a business;
- expenses incurred in developing a new market, etc.;
- expenses incurred in issuing shares or debentures;
- discount on bonds.

(c) The amortization of deferred expenses such as lump-sum payments made to obtain know-how, premium paid for renting premises, etc. is computed in the same manner as the depreciation of intangible assets by applying the straight line method.
(d) Expenditure for research and development paid to specified associations mainly engaged in research work, is deductible in full in the year of payment.

(9) *Royalties:* Royalties are treated as ordinary expenses. A lump-sum payment for an exclusive license is treated as an intangible fixed and depreciable asset.

(10) *Overseas travelling expenses and advertising expenses:* They are deductible to the extent that they are necessary, reasonable and are required for the active conduct of the business.

(11) *Penalties:* Penalties and fines are not deductible, whether imposed on the corporations or on their officers.

(12) *Repairs:* Expenses incurred for repairs and maintenance are deductible in full.

(13) *Bribes:* Deductibility of bribes depends on whether the payment of the bribe is objectively necessary for carrying on the business.

IV. DEPRECIATION

The Corporate Tax Law provides for deduction for depreciation of both tangible and intangible assets (including goodwill). Increased initial depreciation is granted to a corporation filing a blue return[1] on qualifying machinery, equipment and buildings in the accounting period in which the assets are acquired. Accelerated depreciation is granted for certain qualifying assets for certain consecutive accounting periods. Assets which cost less than ¥ 100,000 are deductible when acquired.

The methods of calculating depreciation are the: (i) straight line method; (ii) diminishing balance method; (iii) sum of year's digits method; (iv) production method; (v) replacement method; (vi) any other method specially approved by the District Tax Office.

A corporation may choose one method for each group of its depreciable assets from the depreciation methods mentioned above. The depreciation method must be reported in advance to the tax authorities and a change of depreciation method requires the approval of the tax authorities. Depreciation expenses are deductible for tax purposes to the extent they are entered into the taxpayers' books. The useful lives of fixed assets for computing the charge of depreciation are prescribed by statute. The useful lives in certain cases where wear and tear is faster than usual can be shortened upon approval of the tax authorities. If machinery and plant are used for a longer time than the average, then, upon approval of the tax authorities, extra depreciation is allowed.

The depreciation method for different kinds of depreciable assets, which should in principle be applied, is briefly specified below:

(1) *Tangible fixed assets:* straight line method, declining balance method or other method specially approved by the tax authorities.
(2) *Intangible fixed assets (excluding mining rights and goodwill):* straight line method or other depreciation method approved by the tax authorities.
(3) *Goodwill:* A method in which goodwill is amortized with the amortization limit being the acquisition cost.
(4) *Replacement assets:* straight line method, fixed percentage on reducing balance method or replacement method.

Statutory useful lives. For a better understanding, the statutory useful life of selected assets is shown below:

Description of asset	*Useful life (years)*
(1) Tangible fixed assets other than machinery and equipment	
Reinforced concrete buildings (for office)	65
Wooden buildings (for office)	26
Steel vessels (2000 tons or more)	15
Steel tankers	13
Airplanes	10
Electronic computers	6
Trucks	4
(2) Machinery and equipment	
Chemical condiment manufacturing plants	7
Sugar refinery plants	13
Beer brewery plants	14
Raw silk manufacturing plants	10
Pulp manufacturing plants	12
Chemical fertilizer manufacturing plants	10
Synthetic fiber manufacturing plants	7
Rayon yarn or staple manufacturing plant	9
Plate or sheet glass manufacturing plant	14
Cement furnaces	13
Iron and steel manufacturing plants	14
Electrical machinery manufacturing plants	11
Radio or television broadcasting equipment	6
Hydraulic power generation plant	22
(3) Intangible fixed assets	
Patent rights	8
Utility model rights	5

The statutory useful life of an asset is determined on the assumption that the asset is new and used in the normal manner. This period can be adjusted according to the actual condition of the asset by making application to the Regional Taxation Bureau.

The capital sum recoverable through depreciation is limited to 95%; the remaining 5% is deductible when the assets are written off or disposed. Normally, the accounting of depreciation for tax purposes is the same as for business accounting, but if depreciation for business accounting exceeds the allowable limit for tax purposes, the excess part is disallowed in that year.

Special depreciation. The Corporate Tax Law of Japan provides special depreciation measures to stimulate ac-

1. The blue return system is a tax incentive program designed to secure sound development of the self-assessment system and improvement of taxpayers' accounting practices. Thus, those corporations which maintain such accounts as required under the blue return system and report their income correctly are given certain privileges:
(a) losses may be carried forward for 5 years or backward for 1 year;
(b) special depreciation methods are allowed;
(c) special deduction for overseas transactions of technical services, etc. is allowed;
(d) the amount credited as reserves is allowed as expenses;
(e) in case errors are found in the calculation of taxable income based on the corporation's books and records, the tax authorities can correct the taxable income.

tivities which the Government considers desirable. It should be noted that these measures make no provision for the cumulative amount of depreciation to be more than the cost of the asset but do provide for increased deduction in excess of normal depreciation, thus providing the benefit of the deferred payment of tax so that the company is left with more surplus which may be profitably utilized in other business activities.

The special depreciation methods can be broadly classified into (a) *increased initial depreciation* and (b) *accelerated depreciation*. Increased initial depreciation allows, in excess of normal depreciation, deduction of a portion of the acquisition cost of an asset for the first accounting period in which the asset is acquired, while accelerated depreciation permits a corporation to deduct a part of the acquisition cost of an allowable asset in excess of normal depreciation for certain consecutive accounting periods.

The special depreciation allowance may be credited to a special depreciation reserve account which is treated as tax-free profit in the balance sheet, and one seventh of such special reserve must be added back to income in the succeeding 7 years. Such a reserve thus provides an interest-free loan from the Government but not a reduction of tax.

The allowances for increased initial depreciation and accelerated depreciation for a few selected assets are mentioned below:

Increased initial depreciation

Description of asset	*Percentage of the cost of acquisition*
(a) Qualified machinery and equipment used for:	
(i) prevention of environmental pollution; (small and medium sized enterprises may opt for increased initial depreciation of 18% for the first 5 years)	
(ii) manufacturing in the free trade zone of Okinawa	27
(b) Qualified machinery and equipment used for manufacturing in severely depressed local industrial areas	20
(c) Qualified machinery and equipment:	
(i) designed not to cause environmental pollution	
(ii) for recycling which may contribute to the efficient use of resources	
(iii) for saving of energy	
(iv) used for manufacturing in developing areas	
(v) used to prevent accidents, fire, gas explosions, etc.	
(vi) special water supply equipment for industrial use	
(vii) railway facilities, distribution of gas in urban areas, nuclear plants for generation of energy	
(viii) buildings in the free trade zone of Okinawa which include production facilities	
(ix) electronic computers, but only large ones	20
(d) Qualified machinery and equipment and areoplanes, if the price is more than ¥ 800,000, acquired by small and medium sized enterprises	14
(e) Qualified buildings used for manufacturing and other equipment attached to it in the free trade zone of Okinawa	16
(f) Qualified steel vessels of not less than 500 tons gross (not less than 2,000 tons gross for an ocean-going vessel) owned by shipping companies	15
(g) Qualified equipment used by a medium sized enterprise:	
– Building used for manufacturing and other equipment attached to it in developing areas, excluding Okinawa free trade zone	14
(h) Qualified newly developed high quality plant or equipment with which the electronic equipment is combined	13
(i) Buildings used for manufacturing in undeveloped areas	10
(j) Qualified retail shops jointly operated by many retail merchants	8

Accelerated depreciation

In addition to ordinary depreciation based on statutory useful life, the following accelerated useful depreciation is allowed, if assets come within the following categories:

(a) 32% of ordinary depreciation for the first 5 years, on machinery used by members of cooperatives, textile industries, etc. for promotion of small and medium sized enterprises, or the structural improvement project of textile industry;
(b) 20% of ordinary depreciation of machinery, equipment and buildings of a corporation where not less than 20% of the employees are handicapped persons;
(c) 50 or 75% of ordinary depreciation for newly contructed houses for rent;
(d) 36% of ordinary depreciation for the first 5 years on facilities for storage of crude petroleum;
(e) 32% of ordinary depreciation for the first 5 years on storage facilities such as fireproof warehouses used for trade purposes and silos for grains.

V. RESERVES

While recognizing accepted accounting principles and the desire to attain specific economic policy aims, the Japanese Corporate Tax Law provides for deduction, as an expense, of the amount credited to specified reserves.

It should be noted that these reserves provide for tax deferral but not tax exemption. These reserves can be broadly classified into two groups, i.e. *hikiatekin* (a to e), which are justified by generally accepted accounting principles, and *junbikin* (f to i), which are allowed with a view to attaining certain economic policy objectives.

(1) *Reserve for bad debts.* The amount deductible as reserve is subject to the following statutory limits:

Business of the corporation	*Percentage of receivables*
Retail or wholesale	1.6
Retail on installment payments	2.0
Manufacturing	1.2
Banking and insurance	0.5
Others	1.0

The reserve is treated as income in the following accounting period. The amount of reserve is increased to 116% of the ordinary allowance for corporations with capital of not more than ¥ 100 million.

(2) *Reserve for loss on returned goods unsold.* The amount deductible for such reserve is subject to specified statutory limits and is available to publications, pharmaceuticals, agricultural chemicals, cosmetics etc. The amount credited to such reserve is treated as income in the subsequent accounting period.

(3) *Bonus reserve.* Reserve for bonus is calculated by applying the formula specified in the tax law and such reserve is added back in full in the following accounting period.

(4) *Other reserves.* Reserves for retirement allowances, for special repairs and for repairs and guaranteeing certain products are also deductible subject to certain specified maxima, but are added back to the income in the subsequent accounting period.

(5) *Reserve for price fluctuations.* The maximum amount deductible for such reserves is in principle 1.7% of the book value of inventories. It is proposed to abolish this reserve within 5 or 10 years; during the transitional period, reduced deduction rates will be applicable.

(6) *Overseas market development reserve for small and medium sized enterprises.* Such reserve is allowed to a corporation with capital of not more than ¥ 1 billion and which derives income wholly or partly from overseas transactions comprised of export of goods, or processing of goods by the order of an exporter or large scale repairing of ships, the payment of which is made directly or indirectly in foreign currency. The amount that can be credited to such a reserve for meeting expenses to develop an overseas market is subject to the following limits:

(a) for corporations with capital of not more than ¥ 100 million, 3.6% in case of export of merchandise purchased from others and 8.4% for other exports;

(b) for corporations with capital of more than ¥ 100 million but less than ¥ 1 billion, 0.66% in case of exports of merchandise purchased from others and 0.9% for other exports.

One fifth of the amount credited to the reserve in one accounting period should be added back successively to the income in 5 succeeding years.

(7) *Reserve for overseas investment loss.* If a domestic corporation acquires the stocks of the companies mentioned below which are issued for the creation or the increase of capital of such companies, or it extends credit in the form of loans or purchase of debentures, it can credit a certain amount to a reserve account to meet possible losses of the value by the decline in their prices, etc. Such reserve is deductible subject to the following limits:

(a) specified overseas business company which has its head office in a developing country	15%
(b) specified overseas investment company having its head office in Japan if it is formed in order to invest in specified overseas business companies	15%
(c) nuclear fuel company, i.e. a foreign company which is engaged in recycling of nuclear fuel	40%
(d) specified overseas economic cooperation investment company which is engaged in investing in specified overseas economic cooperation company	25%
(e) specified overseas economic cooperation company engaged exclusively in activities making an important contribution to economic cooperation between Japan and the developing country in which the head office is situated	25%
(f) natural resources prospecting company and investment company which is exclusively engaged in investing in and prospecting for natural resources	100%
(g) natural resources development investment company which is exclusively engaged in making such investment	40%

The amount credited to the reserve may be held for 5 years, but from the sixth year one fifth of such amount should be added back to the income in 5 succeeding years.

(8) *Reserve for investment loss in free trade zones of Okinawa.* If a corporation acquires stock, for the creation or increase of capital, of a manufacturing company whose head office is in the free trade zone of Okinawa, it may credit 15% of the acquisition cost of such stock to such reserve against a fall in the market price of those shares. Such reserve can be held for 5 years but from the sixth year one seventh of such amount should be added back to the income in the succeeding 7 years.

(9) *Other reserves.* Other reserves which are provided by the Japanese Corporate Tax Law for the promotion of its economic policies are mentioned below:

- structural improvement project reserve for small and medium sized enterrises;
- reserve for prevention of mineral pollution of metal mining, etc.;
- depreciation reserve for specific railway construction;

- depreciation reserve for the construction of atomic power generation;
- depreciation reserve for specific gas construction;
- forestation reserve;
- reserve for pollution control;
- stock transaction loss reserve;
- drought reserve, unusual risks reserve, security transaction responsibility reserve, reserve for losses caused by repurchase of electronic computers, and reserve for computer programs.

It must be noted that all these reserves are deductible as expenses under specified conditions but have to be added back to the income in subsequent years. Thus these provide for tax deferral and not tax exemption.

VI. TAX CONCESSIONS

Though the basic philosophy of the Japanese Corporate Tax Law is to provide relief through tax deferral by a wide range of reserves and depreciation allowances, it also provides a few tax incentives especially for promoting exports and in respect of capital gains.

(1) *Incentives for overseas technical service transactions.* If a corporation has derived income wholly or partly in respect of overseas transactions of technical services, it is allowed a special deduction, as follows:

(a) patents, know-how, etc. resulting from research work in the corporation which is alienated or offered in exchange, directly or indirectly, for foreign currency or its equivalent;

(b) copyrights (except for cinematographic films) sold or offered in exchange, directly or indirectly, for foreign currency or its equivalent;

(c) such technical services as planning, consultation, supervision, etc., related to the construction or production of plant or equipment, or specified technical services for agriculture or fisheries or surveys performed in exchange for foreign currency or its equivalent, on condition that the compensation for such services is ¥ 2 million or more per contract.

The deduction, however, shall not exceed 40% of corporate income.

From the examples in the next column it is clear that if a Japanese company exports patent and know-how even at a loss, it would have to pay less tax than if it does not export and can at the same time increase its cash resources.[2]

An explanation of one of the provisions with an attempt to coordinate the economic and legal aspects

Tax incentive for export of patents and know-how in Japan

A few examples are given below which clearly indicate the importance of such an incentive and that, even if the export of patent and know-how is below cost price, it would still be advantageous to Japanese companies, rather than not to export patents and know-how.

This is perhaps one of the reasons which stimulates Japanese companies to enter into a highly competitive and technologically advanced market in the world, as well as enabling them to earn foreign exchange.

Illustration: It is assumed that the rate of tax on a Japanese company is 42%; the cost of providing patent and know-how is ¥ 1,000. Suppose the company exports patent and know-how: (i) at ¥ 1,200; (ii) at ¥ 900; and (iii) if it does not export at all. Assuming the other business income of the company is ¥ 2,000, then

Case I

If patent and know-how are exported at	¥ 1,200	
Income from business		¥ 2,000
Income from export of patent	¥ 1,200	
Less cost	¥ 1,000	¥ 200
Gross taxable income		¥ 2,200
Less tax incentive @ 28% of ¥ 1,200		¥ 336
Taxable income		¥ 1,864
Tax payable @ 42% on ¥ 1,864 : ¥ 783		
Net amount available after taxes ¥ 1,081 + 336 =		¥ 1,417

Case II

If patent and know-how are exported at	¥ 900	
Income from business		¥ 2,000
Income from patent	¥ 900	
Less cost of patent	¥ 1,000	−100
		¥ 1,900
Less tax incentive @ 28% of ¥ 900		¥ 252
Taxable income		¥ 1,648
Tax payable @ 42% on ¥ 1,648 : ¥ 692		
Net amount available after tax ¥ 956 + 252 =		¥ 1,208

Case III

If a company does not export patent	
Income from business, being the gross total income	¥ 2,000
Tax payable @ 42%	¥ 840
Net amount available after payment of tax	¥ 1,160

2. The incentive for export of patents and know-how, copyright, technical service fees, etc. has been considerably reduced in the last few years. The table below shows the high incentive given in the earlier years:

Year	*Special deduction in percentage*		
	Patent, know-how	*Copyrights*	*Technical service fees*
1964-1975	70	30	20
1976-1978	55	20	20
1979	35	10	20
1980	28	8	16

(2) *Incentives for prospecting for mineral deposits in Japan and abroad.* A special deduction is allowed in case of a corporation filing a blue return which has created a mineral reserve to meet expenses in prospecting for mineral deposits. Such a reserve is tax free for 3 years and after that it is treated as taxable income. The amount deductible shall not exceed:
   (a) 13% of the proceeds from sales of minerals mined, concentrated or processed by the corporation; or
   (b) 50% of the income derived with respect to the above-mentioned proceeds. However, the deduction shall not exceed 50% of corporate income.

   If a corporation having a prospecting costs reserve disburses new mineral deposits prospecting costs, or when the corporation having the overseas prospecting costs reserve disburses new overseas mineral deposits prospecting costs, the tax deferral provided above may be converted into an exemption from taxable income.

(3) *Special treatment for capital gains from sale of land or buildings.* The Corporate Tax Law also provides for deferred tax treatment and special treatment in respect of such capital gains when the specified conditions are fulfilled. This is discussed below in detail.

(4) *Investment tax credit.* An investment tax credit was introduced by the 1978 tax reform as a temporary measure to encourage investment by certain small and medium sized corporations in lieu of depreciation on plant and machinery used for energy saving or anti-pollution facilities. Such a credit is subject to a maximum ceiling of 20% of tax due.

VII. CAPITAL GAINS

Capital gains are, as a general rule, included in the ordinary income of the corporation and no tax concession is generally granted, However, there are exceptions to this rule as follows:

(1) *Exchange of properties.* Capital gains on exchange of any land, building, machinery and equipment, etc. which have been held by a corporation for more than one year for any similar property which has also been held by the other party for more than one year are not taxed if such transaction fulfills certain other conditions. This concession grants fair treatment to transactions which do not actually result in income for a taxpayer.

(2) *Expropriated property.* The proceeds of the expropriation of an asset are exempt income upto ¥ 30,000,000, if the asset is expropriated in accordance with the law providing for expropriation. Amounts received in excess of ¥ 30,000,000 are treated as taxable income.

(3) *Insurance proceeds.* The insurance proceeds received for damage to or loss of a fixed asset will not be taxed if the same kind of fixed asset is acquired within 2 years.

(4) *Replacement of business assets.* As an incentive to move from populated areas, if a corporation transfers specified assets consisting of land, building or structures in specified populated areas and acquires similar business assets outside these populated areas; it is allowed to reduce its taxable profits by way of reduced book entry.

(5) *Tax-free transfer of property to a controlled corporation.* When a corporation forms a subsidiary corporation owning 95% of all issued shares of the subsidiary, then the transferred property will not be included in the gross income of the transferor corporation. The subsidiary corporation is required to enter in its books the property it has acquired at the book value of the transferor.

   Similar incentive treatment is given to a new corporation in the electronics and machinery industries and such incorporation as is designated by the Small and Medium Sized Enterprise Modernization Facilitation Law without the above stock holding requirement.

(6) *Reduced book entry (Asshuku Kicho).* The concept of "reduced book entry" is peculiar to Japanese tax law.
   (a) When a corporation receives a subsidy or beneficiary contribution from the national or local government in order to acquire certain fixed assets, then the book value of the above fixed assets entered in the account books of the corporation is reduced by the amount of such subsidies or beneficiaries' contributions and these are excluded from the gross income of the corporation.
   Example:

Fixed assets	200
Book value	100
Subsidy (capital gains)	100

   The subsidy (100) is excluded from income.
   (b) Succession to book value of old property
      (i) Acquisition of new fixed assets if purchased with insurance compensation received for a loss of old property.
      Example:

Book value	100
Insurance proceeds received	200
Loss by fire	100
New book value	100

      The profit of 100 (insurance proceeds minus loss by fire) is excluded from the total income.
      (ii) When a corporation sells property and receives capital gains therefor, and acquires specific property, then this capital gain is excluded from the income if the cost of the acquired property equals the sales price of the property sold.
      Example:

Old property:	Book value	100
	Sales price	1000
	Capital gain	900
New property:	Acquisition cost	1000
	New book value	100

In this case, the capital gain of 900 is excluded from the income.

If the acquisition cost of the new asset is less than the sales price then the proportion of the cost of the new asset to the ratio of the capital gains to the sales price is then excluded from the taxable income.

Example:

Acquisition cost	500
New book value	50

Exclude from total income $500 \times \frac{900}{1000} = 450$

The balance of 450 (900 – 450) is taxable.

VIII. CARRY FORWARD OR BACK OF LOSSES

An interesting feature of Japanese Corporate Tax Law is that it not only allows corporations filing a blue return to carry forward losses for 5 subsequent years, but also allows them to carry back losses for the previous year, thus enabling it to claim a refund of the overpaid tax computed by carrying back of such losses to the income of the accounting year immediately preceding the accounting year in which such loss is incurred.

IX. RATE STRUCTURE

The corporation tax rates are as follows:

(1) Tax rate for ordinary income of a domestic or foreign corporation not distributed as dividends:
- (a) Ordinary corporations
  - (i) Corporations with capital of more than ¥ 100,000,000 . . . . 42%
  - (ii) Corporations with capital of less than ¥ 100,000,000
    - – for annual income of more than ¥ 8,000,000 . . . . 42%
    - – for annual income of less than ¥ 8,000,000 . . . . 30%
- (b) Cooperative associations and public interest corporations 25%

(2) Reduced tax rates for ordinary income distributed as dividends:
- (a) Ordinary corporations
  - (i) Corporations with capital of more than ¥ 100,000,000 . . . . 32%
  - (ii) Corporations with capital of less than ¥ 100,000,000
    - – for annual income of more than ¥ 8,000,000 . . . . 32%
    - – for annual income of less than ¥ 8,000,000 . . . . 24%
- (b) Cooperative associations 21%

Reduced rates are applicable to the amounts distributed as dividends in excess of dividends, if any, received from domestic corporations.

(3) Tax rates for liquidation income:
- (a) Ordinary corporations 35%
- (b) Cooperative associations 21%

Foreign corporations are not liable to tax on liquidation income.

(4) Reduced rate applicable to special domestic medical corporations 23%

(5) Tax rate for retirement pension funds . . . 1%

(6) Special additional tax rates on family corporations
- – Income below ¥ 30,000,000 . . . . 10%
- – Income between ¥ 30,000,000 and ¥ 100,000,000 . . . . 15%
- – Income above ¥ 100,000,000 . . . . 20%

A "family corporation" is a domestic company of which 50% or more of the capital stock is owned by not more than 3 shareholders and persons or corporations connected with them.

X. WITHHOLDING OF TAX

Both domestic and foreign corporations are subject to withholding of tax at source.

Domestic corporations. The following income received by a domestic corporation is subject to withholding of tax:
- – dividends;
- – interest income;
- – remuneration for services of public entertainers.

The tax deducted at source must be paid to the Government before the tenth day of the month following that in which the tax is deducted. Further, credit is given to the corporation against its corporation tax for the tax withheld.

XI. AVOIDANCE OF DOUBLE TAXATION

Unilateral relief is granted to domestic corporations under the Japanese Corporate Tax Law for the foreign corporation tax paid on their foreign-source income. The foreign tax credit can be divided into two categories and is briefly discussed below:

(1) *Ordinary foreign tax credit.* Where a domestic corporation pays foreign corporation tax on its foreign-source income, a credit is provided against the Japanese corporate tax subject to the following limitation:

$$\text{Japanese corporation tax} \times \frac{\text{Total income from sources outside Japan}}{\text{Total income subject to Japanese corporate tax}}$$

Such credit cannot, however, exceed the amount of Japanese corporate tax payable on the world-wide income of the domestic corporation. Withholding taxes on interest and royalties are also creditable.

The excess of foreign taxes over the allowable credit may be carried forward for 5 succeeding years or carried back for the 5 preceding years.

(2) *Indirect foreign tax credit.* Where a domestic corporation receives dividends from foreign subsidiaries, a

credit for the foreign corporate tax attributable to the dividends will be given to the domestic corporation if it holds at least 25% of the total issued capital or voting shares of the foreign subsidiaries for at least 6 months. Further, the foreign subsidiary must be established in the foreign country for purposes of carrying on business and not for tax considerations.

The indirect tax credit is computed as follows:

$$\text{foreign corporation tax on the subsidiary} \times \frac{\text{dividends received}}{\text{net income of the foreign subsidiary after foreign taxes}}$$

This computation has the effect of grossing up the dividends and the foreign corporation tax paid by the subsidiary which is attributable to the dividends.

Tax treaties

Japan has comprehensive double taxation avoidance agreements with Australia, Austria, Belgium, Brazil, Canada, Czechoslovakia, Denmark, Egypt, Finland, France, Germany, Hungary, India, Ireland, Italy, Korea, Malaysia, Netherlands, New Zealand, Norway, Pakistan, Philippines, Poland, Romania, Singapore, Spain, Sri Lanka, Sweden, Switzerland, Thailand, United Kingdom, United States and Zambia. With respect to income for which treatment is provided in the agreement between a treaty country and Japan, then the relevant provisions of the treaty are applicable. Most of these treaties provide relief from double taxation through foreign tax credit.

Power to issue directives

The National Tax Administration has the power to issue directives to its officers for the uniform interpretation and application of laws. These directives are also made public. However, the directives do not bind the courts of justice as a source of law, but are merely an interpretation of the law by the tax authorities. It is important to note that the court of justice seldom decides against the directives. The directives, therefore, play an important role in tax administration.

XII. ANTI-TAX HAVEN MEASURES

On the basis of the findings of the Report on Revisions of the Taxation System for Fiscal Year 1978, submitted by the Tax Council to the Prime Minister in December 1977, the Japanese Diet introduced 2 new sub-sections in the Special Taxation Measures Law dealing with cases of individuals and corporations in Japan which make use of tax haven countries, to reduce their tax liability in Japan.

The new legislation defines "tax havens" as "countries and areas in which the tax burden on all income or on particular types of income of corporations is significantly lower than that on income of corporations in Japan, designated as such by a cabinet order classifying them as countries and areas with low rates of taxation on all forms of income or on particular types of income".

The tax-haven countries have been classified into 3 categories: (1) countries with low rates of taxation on all income; (2) countries with low rates of taxation on income from foreign sources; (3) countries with low rates of taxation on income from specific businesses.

The anti-tax haven measures consist of computing the taxable income of the domestic corporation that is regarded as retained out of "undistributed income" of the special foreign subsidiary of the domestic corporation, multiplied by the proportion of shares held directly or indirectly in the special foreign subsidiary by that domestic corporation.

Taxation of a domestic corporation occurs when the special foreign subsidiaries are corporations located in tax haven countries and in which Japanese domestic corporations or residents hold directly or indirectly more than 50% of the shares issued.

Further, domestic corporations which hold directly or indirectly 10% or more of the shares issued by the special foreign subsidiary, and domestic corporations belonging to a group of stockholders of the same family that hold directly or indirectly 10% or more of the shares as a group, are also taxable on retained income. The condition regarding stock ownership is determined on the basis of the situation existing at the end of the business year of the foreign corporation.

However, the anti-tax haven measures are not applicable if the foreign subsidiary satisfies all the following conditions:

(1) The foreign subsidiary has a fixed facility such as an office, shop or factory which is deemed necessary to conduct its business in the country where its main office exists.

(2) The foreign subsidiary conducts the management and control of its business in the country where its main office exists.

(3) In case the main business of the foreign subsidiary is wholesale, banking, trust, securities business, insurance, shipping or air transport, the foreign subsidiary conducts its business mainly with persons other than related persons.

(4) The foreign subsidiary is not a corporation whose main business is to hold stocks, to offer patents, etc. or copyrights, or to lease vessels or aircraft.

(5) The amount of dividends received by the foreign subsidiary from other foreign corporations which come under these taxation measures does not exceed 5% of its local revenue.

In addition to the above provisions, the new measures also contain provisions to eliminate double taxation with respect to foreign corporation tax imposed on the undistributed income of the foreign subsidiary attributed to the domestic corporation and payment of dividends from already taxed income of the foreign subsidiary.

XIII. CONCLUSION

The success or otherwise of taxation ultimately rests on the reasonableness of the burden which is imposed on the assessees. Excessive taxation may restrict economic incentives and productive efforts, any may cause business activity and national income to decline. If efforts and achievements are recognized, there is no reason why taxes cannot be used creatively to achieve the economic goal of the nation.

As a fiscal tool, taxation policy has to be directed at productive resources which are necessary for the economic development, but which the private sector is unable to provide for. Such a step towards direction of resources is needed by both the developed and developing countries according to the state of their economy and international economic situation.

The above study on corporate taxation in Japan illustrates the efforts on the part of the Government to use a taxation policy for her economic development which has qualities that could with advantage be adopted by other countries. It would not be an exaggeration to say that if the Japanese economy were to sneeze now, the entire world would catch a cold.

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The Development of Double Taxation Conventions with Particular Reference to Taxation of International Air Transport*

by D. Hund**

1. INTRODUCTION

One of the problems which almost inevitably have to be faced in any international operations is that of double taxation. And if one type of operation is virtually by definition international in character it is air transport. The second report of the OEEC Fiscal Committee of 1959 (in 1961 rebaptized OECD), which preceded the 1963 OECD Draft Double Taxation Convention, notes: "By the nature of their business, shipping, inland waterways transport and air transport enterprises are more exposed than most other industrial and commercial enterprises to the danger of multiple taxation on their income, as they are liable to be taxed simultaneously in their own countries and in the other countries where they receive payment for the carriage of passengers or goods or where their activities are exercised." The International Civil Aviation Organisation (ICAO) Council Resolution of 14 November 1966 expresses itself in similar terms.

Double taxation obviously forms a serious obstacle to running an internationally oriented business like an airline. It goes without saying, therefore, that action to prevent double taxation is of particular importance to airlines.

2. THE PREVENTION OF DOUBLE TAXATION

There are two main ways of setting up schemes to combat double taxation: unilateral schemes at the national level and international measures on a bilateral or multilateral basis. Many countries make it possible to exempt foreign airlines from taxation on a basis of reciprocity. In effect this is a national regulation. Bilateral regulations mean first and foremost comprehensive conventions for the avoidance of double taxation on income and capital. A variation on this theme is formed by conventions which restrict themselves to the avoidance of double taxation on profits from international air transport and/or from merchant shipping. A third possibility is offered by air transport agreements, which mainly relate to landing rights, capacity problems and route sharing. Also here a provision could be inserted relating to the avoidance of double taxation on any profits made by the operations in question. I do not want to express any preferences on these methods here. What I do want to talk about is the use of comprehensive tax conventions to avoid double taxation on profits from international air transport operations.

3. MODEL CONVENTIONS

The history of air transport goes back nearly a hundred years, but the present network of world-wide routes was not conceived until after the first world war. It is interesting to note that the period in which wider international attention began to be paid to the phenomenon of double taxation in general coincides more or less with the earliest days of international air transport, the 1920s, and that the tax position of air transport was treated separately more or less from the start.

In 1921 the League of Nations commissioned a panel of 4 experts to study the economic aspects of international double taxation. Their first report appeared in 1925. It said – and this was repeated in the recommendations attached to the report – that international *shipping* should be taxed according to a regime other than that which applied to ordinary businesses. Air transport was not considered at that time. However, the report led to a conference which was held in Geneva in 1928 and one outcome was a model convention for the prevention of double taxation in the special matter of direct taxes. There were 3 versions of this convention in order to facilitate adjustments to the various tax systems of the states taking part in the conference. Each of the 3 versions makes the levying of taxes on business profits outside the country where the enterprise has its fiscal domicile dependent on the presence of a permanent establishment. Each version adds the following provision, however: "Nevertheless, income from maritime shipping *and air navigation* . . . shall be taxable only in the State in which the real centre of management is situated." The Commentary on the 3 versions notes that the provisions on sea and air transport form an exception to the principle which normally applies in the case of enterprises, but gives no further explanation.

The League of Nations' work in the area of tax conventions was continued and led to 2 new model conventions: the *Mexico* convention of 1943 and the *London* convention of 1946. The Mexico draft devotes a separate article to shipping and air transport for the first time: Article 5. This reads: "Income which an enterprise of one of the contracting States derives from the operation of ships or aircraft registered in such State is taxable only in that State." Assuming that "an enterprise of one of the States" in most cases has its real centre of management there, we thus can establish that the basis of the Geneva document, i.e. that tax should be levied only in the country where the airline is established, is retained although *registration* in that country is also required. The commentary states that this is simply following the principle which had already been laid down in numerous bilateral conventions. I shall return to this point later.

Article 5 of the 1946 London model is also specially devoted to international air and sea transport: "Income

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which an enterprise of one of the Contracting States derives from the operation of ships or aircraft engaged in international transport is taxable only in the State in which the enterprise has its fiscal domicile." Although here also precedence is given to domicile, it differs from the Mexico model in two ways. the requirement for registration has been dropped but there has been added the provision that the profit must have been obtained *in international transport.* Nevertheless the commentary states that the new wording is intended to make it still more explicit that "income from international maritime and air transport [is] taxable only in the country where the vessel is registered, provided the owner or operator has its fiscal domicile in that country". The provision is also intended "to facilitate the operation of international transport enterprises".

The demise of the League of Nations also put an end to its work in fiscal matters. Attempts to achieve model conventions continued elsewhere, however. The British Commonwealth produced a Model Commonwealth Taxation Agreement in 1964, for example. It too contains a special provision for international maritime and air transport under which taxation is levied only in the country of domicile.

The Andean Pact States in South America also drew up a model agreement, in 1971. Here the principle for air and maritime transport, laid down in Article 8, is once again taxation in the country of domicile, although the members of this organisation are well known as tenacious defenders of the principle of taxation in the source country. Nevertheless they were obviously not in complete agreement, for the model also contains an alternative Article 8: "The profits earned by a transportation enterprise from its air, land, sea, lake or river operations in any of the Contracting States, shall be taxable only by such Contracting State." In other words: taxation in the source country. The two possibilities are also embodied in Article 19 of a model convention that was published by the successor to the Andean Pact, the Latin American Free Trade Association (LAFTA).

What we have here for the first time is a departure from the principle that taxation takes place exclusively in the country of domicile which, as I said earlier, had been stipulated in the case of maritime and air transport from the earliest model conventions onward. I shall return to this point at a later stage.

Far more important is the work on model conventions undertaken by what was originally the Organisation for European Economic Cooperation (OEEC), later the Organisation for Economic Development and Cooperation (OECD). The organisation's model/draft conventions for the avoidance of double taxation on income and capital of 1963 and 1977 have had a tremendous influence on the bilateral double taxation conventions concluded over the past 20 years. Here again international sea and air transport is treated separately from other enterprises: Article 8, paragraph 1, which is identical in the two models, states: "Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated." The commentary to the OECD models, however, does not give the reasons which led to this treatment, which differs from the normal regime for profits. Presumably it was supposed that this treatment was at that time so widely accepted internationally that no explanation was necessary.

The most recent in the series of model conventions is the United Nations model double taxation convention between developed and developing countries, which dates from 1980. A group of experts from both developed and developing countries had been working on this model since 1968 and it differs from the OECD model conventions on a number of generally predictable points. As was evident in the Andean draft, developing countries are naturally more inclined towards greater powers of taxation for source countries than are the developed countries. Thus the UN model contains a wider interpretation of the term "permanent establishment" and higher rates of taxation at source on income from movable capital than are usually agreed between developed countries. In so far as shipping and air transport is concerned, the experts were unable to agree upon a common solution and as a result the model contains two alternatives. Article 8A, paragraph 1, is word for word the same as Article 8, paragraph 1 of the OECD models. Article 8B, on the other hand, provides for the right of the source country to levy taxes in the case of *shipping* but the principle of taxation solely in the country of domicile is maintained for *air transport.* The commentary on Article 8A, paragraph 1, states: "The exemption from tax in the source country of foreign enterprises engaged in international shipping traffic is predicated largely on the premise that the income of these enterprises is earned on the high seas, that exposure to the tax laws of numerous countries is likely to result in double taxation or at best in difficult allocation problems, and that exemption in places other than the home country ensures that the enterprise will not be taxed in foreign countries if their over-all operations turn out to be unprofitable. Considerations relating to international air traffic are similar."

Finally, mention should also be made of the United States Treasury Department Model Income Tax Treaty, which was first published in 1976 and partly revised in 1977; a new draft has recently been issued. In effect it is a standard draft that the United States tends to use as basis in its negotiations rather than a model treaty. All 3 published versions likewise lay down the principle that taxes on air and maritime transport are levied exclusively in the country in which the enterprise is established.

The conclusion from all this is that the position of international air transport in model conventions has remained essentially unchanged in over 50 years, i.e. taxation is levied exclusively in the country of domicile or of effective management.

Before discussing how much of this principle has remained intact in bilateral tax conventions, I should like to say a few words about some *multilateral* conventions.

4. MULTILATERAL TAX CONVENTIONS

The problems that arise in bilateral relationships pale beside those of multilateral ones. For this reason there have only been a few multilateral double taxation conventions in the past, none of which has had any great significance. I shall just briefly mention 4 examples:

(1) the 1963 convention between francophone African states;
(2) the multilateral Andean Pact convention of 1971;
(3) the Arab convention of 1973;
(4) the Comecon convention of 1979.

The francophone African convention contains a major departure from the domicile principle in applying the main rule for companies, i.e. taxation in the source state, but dependent on the presence there of a permanent establishment, to air and maritime transport. The Andean Pact convention, on the other hand, does provide for taxation exclusively by the state of domicile, which is also the case with the Arab convention and the Comecon convention (or multilateral Convention between the members of the Council of mutual economic aid (CMEA), as the Eastern European economic community is called).

Here too, then, there is an almost universal acceptance of the domicile principle.

5. BILATERAL TAX CONVENTIONS

The earliest comprehensive conventions for the avoidance of double taxation date from the beginning of this century. Since then over 500 of them have been concluded. You will forgive me for not having gone through all of them to check the provisions relating to air transport. However, I have gone some way towards doing this by looking at the provisions in the tax conventions concluded since 1965 and published by the United Nations. There are over 300 of them, and only a very small number, about 4%, provide for taxation in the source country (see Annex). This is hardly surprising in view of what I have just said about the model conventions and their enormous influence on treaty practice.

I have tried to see whether certain groups of treaties show any particular fixed pattern. First of all there is the group of developed countries, essentially the 24 member states of the OECD. There are some 200 treaties between these states, that is about 75% of the possible permutations and combinations between them. Almost without exception the provisions on air transport in these conventions follow Article 8 of the OECD models, that is taxation in the state of domicile. This is not surprising as the OECD formula provides for the possibility of a country making a reservation on any provision of the model convention with which it disagrees. None of the member states has made such a reservation with regard to air transport.

There are hardly any general tax conventions between OECD countries and Arab states. Given the attitudes on both sides – I refer to the Arab Convention I just mentioned – it is not likely that air transport would prove a stumbling block in negotiations. This may be the case, however, in relationships between developed and developing countries, in spite of the UN model convention, which puts air transport in a favourable position. Nevertheless, 119 of the 136 conventions in this category still follow the domicile principle. The proponents of taxation in the source country are only a small group: Singapore, Malaysia, Sri Lanka and the Philippines. With this in mind, it is worth noting the tax convention between the United States and the Philippines, whose ratification has been dogged for years by problems, partly due to the provision relating to air transport. It is remarkable that only one of the 10 conventions between developing countries that I have looked at provides for taxation in the source country. The last group I would like to mention is that of conventions with Eastern European countries which date from the last 10 years or so. Without exception, they uphold the principle of taxation in the country of domicile.

And last, but not least, my own country, the Netherlands: at present there are 32 conventions in force and 3 signed but not yet ratified. We are strongly in favour of placing as few fiscal obstacles in the way of international air transport as possible and we heartily support the OECD principle which, I take it, is also held by IATA: taxation exclusively in the state of effective management of the enterprise. We have been able to ensure that this principle has been respected in all the conventions we have concluded, with only one exception the convention with Singapore.

CONCLUSION

It may be seen that international air transport has occupied a special place in double taxation conventions from the very beginning. This in itself is a remarkable situation, for an airline is an enterprise and as such there is no reason to arrange the taxation of its profits in a way which departs from the internationally accepted practice for other enterprises, that is taxation outside the country of residence being made dependent on the presence of a permanent establishment. As we have seen, however, airlines have been treated differently for over 50 years.

There are two main reasons for this, one theoretical and one practical. The theoretical backgrounmd for exemption in the source country is that the profits of an airline are not primarily obtained where passengers and freight are loaded. No, the activity that produces the profits in the first place is flying and that is done mainly in international air space. The practical argument against treating airlines according to the same rules as other enterprises is the fact that it is almost impossible to arrive at an acceptable method of dividing profits between the various permanent establishments and the headquarters.

I realise that I have only been able to deal with certain aspects of the taxation of international air transport. I have not discussed the interpretation of the term "international traffic". Nor have I considered what exactly should be understood by "profits from air transport". Nevertheless I hope that I have been able to give you some idea of the historical development of international air transport from an international fiscal point of view. It is fair to say that it is accepted on a more or less worldwide scale that as few fiscal obstacles as possible should be put in the way of international air transport. In practice this means that taxation is levied only in the airline's home country. I have also pointed out that the Netherlands shares this principle and that it has been able to maintain it in some 35 general double taxation conventions, but also in a number of more restricted conventions, air transport agreements and a number of declarations on the basis of reciprocity.

It is therefore possible to state that the ICAO Council Resolution of 14 November 1966, which recommended the member states to take all possible steps to grant international air transport profits exemption from taxation on a basis of reciprocity, and which recommendation has since been repeated a few times, has been followed to a large extent by treaty concluding countries.

We should also note, however, that a number of developments around the world may make continuation of existing practices more difficult. First of all there is the increasing tendency of certain host countries, mainly developing countries, to make foreign airlines liable to taxation, even in spite of the UN model convention and in most cases despite the absence of a permanent establishment. But what is even worse: taxation is often not levied on a net basis but on a notional amount of profit which is not subject to revision in the light of actual profits. In this connection I should like to refer to the report which your organisation published in 1975, entitled "Taxation of international air transport, net income basis, an alternative to reciprocal exemption".

A second unfavourable development is the fact that one is increasingly confronted in practice with countries which, in spite of repeated urging, are not prepared even to discuss the problems of international air and maritime transport as they relate to double taxation. This means that the question of how to devise a suitable scheme cannot even be raised. A variation on this theme is the increasing unwillingness to deal with air and sea transport in anything other than a comprehensive double taxation convention. This makes any scheme partly dependent on the solution of problems which often have nothing to do with international transport.

A third development which, in my opinion, has to be rejected is the fact that some countries are only prepared to do business if exemption is granted for all taxes and levies which have some, sometimes distant, relation to air transport. Of course it is an honourable starting point. By no means, however, should the ultimate goal – taxation of profits from air transport only in the country of residence – be endangered by making a reciprocal exemption on such profits dependent on the willingness to grant exemption as well for all kinds of indirect taxes, sometimes even together with the demand to grant the airline's staff a kind of diplomatic status. Part of those matters is dealt with in air bilaterals. For others, a solution seems complicated. Anyhow, they should be dealt with separately.

The last unfavourable development I should like to point out – and one which has so far been mainly restricted to merchant shipping – is the increasing tendency of certain countries to give preferential treatment to their own companies. It is true that foreign lines are usually exempted from taxation but their opportunities for loading or unloading freight or for enabling passengers to embark or disembark are often drastically restricted, thus reducing the opportunities to realise profit and frustrating the effect of the exemption.

In my opinion these developments should be most emphatically rejected in the interests of the unimpeded exploitation of international airline services.

ANNEX

1	2	3	4	5	6	7	8	9
Contracting parties	*Period*	*Conventions signed*	*State of effective management*	*+ registration*	*State of residence*	*+ registration*	*State of source*	*No specific provision*
Developed countries	1956–1960	31	13	2	11	5	–	–
	1961–1965	28	19	1	4	4	–	–
	1966–1970	50	27	–	19	4	–	–
	1971–1975	28	13	–	–10	4	–	–
	1976–1980	12	5	–	7	–	–	–
		149	77	3	51	18	0	0
Developed country–developing country	1956–1960	21	1	1	16	2	1	–
	1961–1965	30	8	1	15	1	4	1
	1966–1970	33	4	–	20	4	3	2
	1971–1975	31	13	–	14	1	3	–
	1976–1980	21	6	–	11	1	1	2
		136	32	2	76	9	12	5
Developing countries	1956–1960	4	–	–	4	–	–	–
	1961–1965	–	–	–	–	–	–	–
	1966–1970	3	–	–	2	–	1	–
	1971–1975	3	2	–	1	–	–	–
	1976–1980	–	–	–	–	–	–	–
		10	2	0	7	0	1	0
Developed country – Eastern European country	1971–1975	6	3	–	1	2	–	–
	1976–1980	6	3	–	3	–	–	–
		12	6	0	4	2	0	0
	Total	307	117	5	138	29	13	5

U.S.A.:

SAFE HARBOR LEASING – A Controversial Means for Distribution of Investment Incentives

by Frank J Schuchat *

Of all the provisions in the Economic Recovery Tax Act (ERTA) enacted by the United States Congress in 1981, perhaps the one generating the most public discussion is Section 201, which, by adding Section 168(f)(8) to the Internal Revenue Code, makes it easier for an entity with tax credits or depreciation deductions in excess of an amount it can take full advantage of, due to a lack of taxable income, to transfer those tax benefits to another, profitable entity, in return for cash.

The so-called safe harbor leasing provision of the ERTA is designed to allow all corporations to take advantage of the new Accelerated Cost Recovery System (ACRS),[1] which permits recovery of capital investments in certain productive assets over a shorter period of time than was previously allowed, as well as the 10% Investment Tax Credit (ITC).[2] Both ACRS and the ITC are measures to encourage capital investment, which is seen as the key to economic recovery. Without safe harbor leasing, it is argued, there would be distortions in the economy, due to uneven distribution of tax incentives, with older, profitable corporations receiving a competitive advantage over new enterprises and those suffering losses during the years the tax incentives are available to them. In addition, the accumulation of unused tax benefits is said to make some corporations attractive targets for takeovers, which would also reduce competition.

The "tax sales" which have so far taken place under Section 168(f)(8) have created a furor in the press, among citizens' groups and in the Congress, based on objections to the high cost in lost revenue (which according to Treasury estimates could exceed $27 billion by 1986), at a time when most Federal programs are on austerity budgets, the deficit is expected to reach record levels, and the administration is exhorting the public on the benefits of living with less government assistance. This article will discuss the mechanics of safe harbor leasing as well as some of the arguments put forward by those who would keep it in the Code and those who favor its elimination.

BACKGROUND

The general form for the transfer of tax benefits under the new provision is illustrated by the following two examples taken from the Temporary Regulations issued by the Internal Revenue Service.[3]

In the simple leasing transaction, X Corp. would like to acquire a $1 million piece of equipment, which is "qualified leased property" as defined by the statute, and which has a 10-year economic life and under ACRS can be depreciated over an accelerated period of 5 years. Y Corp. meets the requirements of Section 168(f)(8)(B) for a lessor, which will be discussed below, and has profits it wishes to shelter from tax. Y will purchase the equipment selected by X from the manufacturer for $1 million, paying $200,000 in cash and borrowing the remaining $800,000 from a bank, with a repayment schedule calling for 9 equal annual installments of principal and interest of $168,000. Y then leases the equipment to X under an agreement calling for 9 annual rental payments of $168,000. Both corporations elect to have the transaction characterized as a lease and to have the special rules of Section 168(f)(8) apply. Y will be treated as the owner of the property for federal income tax purposes and is therfore entitled to the investment tax credit and the ACRS deductions with respect to the property. Y will have a basis of $1 million in the property and must report the rental payments as ordinary income. Y will, however, be able to deduct from gross income the interest paid to the bank on the $800,000 loan. X will be permitted to deduct as a business expense the aggregate payments of rent.

In the sale and leaseback transaction the facts are the same except that X has already purchased the machinery for $1 million and enters into an arrangement with Y to transfer to it ownership of the property for federal tax purposes. In order to accomplish this, X will agree to sell the machinery to Y for an initial payment of $200,000 in cash, plus a note for $800,000, calling for repayment of principal and interest over a 9-year period in annual installments of $168,000. X, which has now transferred title to the property (but has retained possession), will agree to lease the property for 9 years with rental pay-

* J.D., Member of the Staff of the International Bureau of Fiscal Documentation.

1. IRC Section 168.

2. IRC Sections 38; 46. U.S. law permits a credit against tax for amounts invested in certain depreciable property. The credit is generally available in the year the property is first placed in service, and is currently 10% (prior to 1975 the credit was 7%). The adjusted basis of the property is not reduced by the amount of the credit. In effect the provision reduces the cost of capital expenditures, with the intent of encouraging productive investment.

3. Temp. Reg. Section 5c. 168(f)(8)(-1)(e). Treasury Decision 7791.

ments totalling $168,000 per year. Again, the two corporations will elect treatment under Section 168(f)(8) and are therefore assured the transaction will be treated as a lease for federal income tax purposes.

The rental payments which X is required to make to Y are exactly equal in timing and amount to the debt service payments that Y must make on the note. Therefore, the two sets of payments cancel out each other and the only cash that need change hands between X and Y is the original $200,000, which is the cost to Y of securing the tax benefits that accompany ownership of the equipment, i.e. the investment tax credit and the ACRS deductions. Y's basis will be $1 million and it must report as income the rent it receives from X; however, that income is offset by the deduction for the interest paid to X on the note and the annual depreciation. X need not recognize a gain on the sale since the sale price of $1 million equals its basis in the property. X must report interest on the note as income but may deduct rental payments.

In either example, the user of the property, X, may have an option to purchase the property at the end of the lease period for a nominal price or a determinable price, and this will not affect the characterization of the transaction as a lease, nor will it be taken into consideration in determining the amount the lessor has "at risk" with respect to the property.

PRE-ERTA LEASING

Prior to enactment of Section 168(f)(8), it was possible to transfer tax credits or deductions through a leveraged lease; however, there was no "safe harbor", and the transaction had to meet specific guidelines in order to qualify for an IRS letter ruling characterizing it as a lease rather than a conditional sales contract.[4] The lessor had to have a minimum unconditional "at risk" investment in the property at all times of 20% of the *cost* of the property. Such minimum investment had to be an equity investment which, in this context, included only consideration paid and personal liability incurred by the lessor to purchase the property. The net worth of the lessor had to be sufficient to satisfy such personal liability and the lessor had to demonstrate that an amount equal to at least 20% of the original cost of the property was a reasonable estimate of the fair market value of the property at the end of the lease term. The property also had to have a remaining useful life at the end of the lease term of the longer of one year or 20% of the originally estimated useful life of the property.

The lessee was not permitted to have a contractual right to purchase the property from the lessor at a price less than the fair market value at the time the right was exercised and the lessor could not have a contractual right to cause any party to purchase the property, at the time the property was first placed in service or use by the lessee. The lessee could not furnish any part of the cost of the property, nor could he lend to the lessor funds required to purchase the property, nor guarantee any indebtedness created in connection with the acquisition of the property by the lessor. Finally, the lessor had to be able to demonstrate an expectation of profit from the transaction, apart from the value of or benefits obtained from the tax deductions, credits, allowances and other tax attributes arising from the transaction.

THE NEW RULES – A SAFE HARBOR

What the new law does is to deliberately ease the former requirements in order to encourage tax leasing. To qualify for the safe harbor, i.e. a guarantee of treatment of the transaction as a lease for federal tax purposes, the parties involved must first of all elect to treat the transaction as a lease rather than a financing arrangement. However, not all taxpayers may participate in tax leasing. To qualify as a lessor in one of these arrangements one must be a corporation other than a subchapter S corporation or a personal holding company, a partnership all of the partners of which are eligible corporations, or a grantor trust with respect to which the grantor and all beneficiaries are corporations or a partnership composed of corporations.[5]

The nominal lessor is also required to have, at all times during the lease term, a minimum investment "at-risk" in the property of at least 10% of the adjusted basis of the property. Although this "at-risk" requirement is a continuation of the old policy of insisting the nominal lessor have a stake in the cost of the leased property, it is less of a stake than under the previous guidelines, since it need only be 10% rather than 20%, and, more importantly, it is determined with respect to the adjusted basis of the property rather than the original basis.

The fact there may be an agreement between the lessor and the lessee requiring either or both parties to purchase or sell the property at some price (whether or not fixed in the agreement) at the end of the lease term will not affect the amount the nominal lessor is considered to have "at risk" with respect to the property. The fact the lessee is considered the owner for state or local law purposes will also not be taken into account in characterizing the transaction as a lease. It will not matter either that after the lease term no other person besides the lessee will be able to make use of the property.

4. See Revenue Procedure 75-21, 1975-1 Cumulative Bulletin 715; Revenue Procedure 75-28, 1975-1 Cumulative Bulletin 752; Revenue Procedure 76-30, 1976-2 Cumulative Bulletin 647.

5. A Subchapter S Corporation is a true corporation which is treated as a partnership for Federal income tax purposes, i.e. corporate income is exempt from federal income tax with regard to the corporation itself, but is taxable for the individual shareholders, whether distributed or not. The shareholders must be fewer than 25, they must elect Subchapter S treatment, and must have only one class of stock (IRC Section 1371).
A personal holding company is a corporation subject to the personal holding company tax, which is imposed annually on all corporations which fit certain definitional requirements, regardless of whether their purpose was to avoid tax. Essentially, a personal holding company is an investment company, in which the majority of stock is held by 5 or fewer persons, and the bulk of its income is from dividends and interest (see IRC Section 541).
A grantor trust is a trust of which the grantor will be treated as the owner of the trust's assets for tax purposes, in general because certain attributes of control have been retained (see IRC Section 671).

Another change from the old IRS guidelines is that the lessee, or a related party, may now provide financing, or guarantee financing for the transaction. That does not, however, allow the lessee to finance or guarantee the 10% minimum "at-risk" investment required of the lessor.

The lease term (including extensions) may not exceed the greater of 90% of the useful life of the property for purposes of Section 167 depreciation, or 150% of the present class life of the property.[6]

In order to be "qualified lease property" the property must meet one of 3 requirements, the first of which is that it is new Section 38[7] property of the lessor which is leased within 3 months after the property was placed in service, and which, if it had been acquired by the lessee, would have been new Section 38 property of the lessee. (The lessor may use the property within the 3-month period prior to the start of the lease.)

In case of a sale-leaseback transaction, "qualified property" includes property that was new Section 38 property when acquired by the lessee. The sale and leaseback must occur within 3 months of the date the property was placed in service by the lessee, and the adjusted basis of the lessor must not exceed the adjusted basis in the hands of the lessee at the time of the lease. A special rule applies for eligible property placed in service after 31 December 1980, and before the date on which the ERTA was enacted (13 August 1981). Such property will be deemed to have met the 3-month requirement if leased by 13 November 1981.[8] The third category of "qualified property" is mass commuting vehicles (as defined in IRC Section 103(b)(9))[9] which are financed in whole or in part by obligations the interest on which is excludable from income tax under Section 103(a). This special category, under which a lessee will receive the depreciation deduction even though the property is used by a tax-exempt organization or government unit in an exempt function, does not, however, qualify for the investment tax, credit, but only for the ACRS deductions.

The act states that, if the specified requirements are met, no other factors will be taken into account in determining whether the transaction will be effective to transfer federal tax attributes to the nominal lessee. The Treasury Department is authorized by the Act to promulgate regulations as may be necessary to carry out the purposes of the section, including regulations to insure that the aggregate amount of (and timing of) deductions and credits in respect of qualified leased property is limited to the aggregate amount (and timing) which would have been allowable without regard to the leasing provisions.

In case the lessee acquires the property at the expiration of the lease term, and subsequently disposes of it, the lessee will be subject to the normal rules for recapture of depreciation deductions under IRC Sections 47 and 1245,[10] just as if the lessee had been considered the owner of the property for the entire term of the lease. However, any amount recaptured already from the lessor when it transferred the property will not be recaptured again from the lessee.

REVISION OF REGULATIONS

In October 1981,[11] the Treasury announced regulations for safe harbor leasing which provided guidelines as to what subsequent events might disqualify a leasing transaction from safe harbor protection. Among the specified events was a transfer in bankruptcy or similar court-supervised proceeding. This set off a storm of criticism since, in the words of one concerned corporate executive, the effect of the regulations was "nearly to destroy the ability of poor companies with dubious credit to take advantage of the new law".[12] Since it was "poor" companies, or at least companies with a negative taxable income, which were the intended beneficiaries of the safe harbor leasing provision, the temporary regulations were subsequently amended.[13]

As it now stands, a transfer in bankruptcy or similar proceeding is not automatically a disqualifying event if (1) all lenders with secured interests in the property prior to the time the lease is consummated consent to release the federal income tax ownership of the property from their interest, (2) the lessor gives written notice of its tax ownership to the court, the trustee in bankruptcy, and the purchaser of the property, and (3) the lessor files a statement with its income tax return identifying the transferees and the property. All that having been done, the lessor will continue to be owner of the property for tax purposes, and the transferee will step into the shoes of the original lessee. The rule is mandatory for agreements executed after 31 May 1982, and elective for those before that date.

If, on the other hand, the lessee voluntarily sells or assigns its interest in the lease or in the property, the arrangement *does* lose its characterization as a lease under

6. IRC Section 167(m)(1). Under the Class Life Asset Depreciation Range (ADR) system taxpayers were permitted to base depreciation deductions on a hypothetical useful life selected from within a range specified for designated classes of assets.
7. Section 38 property is property that may be depreciated annually and for which an investment tax credit is available. The category generally includes tangible personal property (except air conditioning and heating units); certain other tangible property (except buildings) tied to production or certain services; some research and storage facilities; qualified expenditures for rehabilitating business buildings; certain agricultural and horticultural structures and certain reforestation expenses.
8. This deadline caused a flurry of activity in September and October of 1981 as corporations rushed to qualify for leasing property already purchased and placed into service.
9. This provision exempts from tax interest paid on municipal bonds used to finance purchases of buses, subway and rail cars to be used by mass transit systems owned by government units. The theory is that by exempting interest from tax local governments can offer holders of their obligations an attractive yield at a lower cost to the local government. By permitting tax leasing of mass commuting vehicles, capital costs are further subsidized.
10. If property for which accelerated depreciation deductions or a credit have been taken is disposed of prior to the end of its useful life or the ACRS recovery period, part of the tax benefits are "recaptured", i.e. paid back to the Treasury.
11. Temporary Regs. Section 5c. 168(f)(8). Treasury Decision 7791.
12. Letter of 27 October 1981 from Chrysler Corporation President Lee A. Iacocca to Treasury Secretary Donald T. Regan, reprinted in *Tax Notes,* 16 November 1981, p. 1215.
13. Treasury Decision 7795.

the safe harbor provision, unless within 60 days of the transfer the lessee's transferee gives written consent to take subject to the leasing of the tax attributes of the property to the nominal lessor.

Under the new regulations it is intended that corporations will have the flexibility needed to make maximum use of Section 168(f)(8) so that, as Congress intended, the lessee will obtain the benefit of capital investment incentives in an amount as near as possible to the tax incentives it would have received had it been able to take advantage of the ACRS deduction and the Investment Tax Credit without having to resort to a lease.

A QUESTION OF POLICY

The old guidelines, which made leverage leasing complicated and resulted in high transaction costs, were designed to insure that only genuine arrangements were recognized for federal tax purposes. In contrast, the new regime will be easier to work with because it represents more than simply a change in mechanical requirements or an easing of reporting obligations. As stated in the *General explanation of the Economic Recovery Tax Act of 1981,* prepared by the staff of the Joint Committee on Taxation, the new provision is

> . . . a significant change overriding several fundamental principles of tax law. Traditionally, the substance of a transaction rather than its form controls the tax consequences of a transaction. In addition, a transaction generally will not be given effect for tax purposes unless it serves some business purpose aside from reducing taxes. Because the leasing provision was intended to be only a transferability provision, many of the transactions that will be characterized as a lease under the safe harbor will have no business purpose (other than to transfer tax benefits). When the substance of the transaction is examined, the transaction may not bear any resemblance to a lease.[14]

However, to admit that a safe harbor for leverage leasing serves no business purpose save for reducing taxes does not mean that transferability of tax benefits does not serve any legitimate public objective. The investment tax credit and accelerated depreciation are intended to lower the cost of capital to firms in order to encourage capital investment, which is considered the key to economic growth. When some firms cannot take advantage of these incentives not only are their capital costs not decreased, they are in fact increased relative to other firms. This distortion should be addressed in some way. Therefore, we have the Congress encouraging leverage leasing by creating a safe harbor.

The basic principle is summed up in the following passage from an address by the Assistant Treasury Secretary for Tax Policy, John E. Chapoton:

> What tax leasing guarantees is that the investment stimulus of ACRS will be available equally to all firms which make new investments, whether or not the particular firm has significant current income. The choice of investments made in the economy will be determined by the economic profitability of the investments, not by special tax benefits available only to certain firms with particular tax characteristics. Far from being a special interest benefit for distressed industries or cash rich companies, leasing is a tool for spreading the investment stimulus of the new tax law more equally throughout the economy . . . . safe harbor leasing, which allows more efficient leasing transactions than under prior law, is an essential ingredient of the new ACRS rules.[15]

Since passage of the ERTA, corporations have been quick to arrange leasing transactions to take advantage of the new safe harbor provision. This has created considerable publicity, mostly adverse, which has in turn prompted several members of Congress to propose legislation to repeal Section 168(f)(8).[16] Whether or not such efforts will be successful remains to be seen.

Under temporary regulations issued by the Treasury, safe harbor leases are to be reported within 30 days after the transaction is executed,[17] so that when the Congress does reconsider Section 168(f)(8) it will be able to draw upon useful current data in considering how effective the provision has been. Nevertheless, the result of its reconsideration will hinge as much on politics as tax policy.

Although opposition to Section 168(f)(8) is based for the most part on its cost to the Treasury, and not on its effectiveness in dealing with the problem of distributing tax incentives made available in other parts of the Internal Revenue Code, the section can also be faulted in that respect.

According to one estimate, companies that "sell" their tax benefits appear to be getting about 60% of the value of those benefits.[18] That means that although the benefit results in a loss to the Treasury of the full amount which the lessee would have been entitled to had it been able to use the benefits itself, the intended beneficiary of the investment incentive, the lessee, gets much less assistance than the government has paid for. This is plainly not efficient. In addition, the fact that profitable corporations are able to take substantial deductions and credits by becoming tax lessors can undermine public confidence in the revenue system. On the other hand, if only profitable enterprises are able to take advantage of tax credits and deductions that are intended to apply across the board, there is also a risk that some corporate taxpayers will perceive the sytem as inequitable.

Accordingly, if the government is to continue to provide incentives to capital investment through the tax system, it may be necessary to consider alternatives to leverage leasing as a means for allowing all corporate taxpayers to take advantage of the incentives. The most obvious alternative is a refundable tax credit, i.e. a system where corporations without tax liability to offset would be given a payment in the same amount they would otherwise receive as a tax credit. Such a scheme might be complicated to administer. Neverthless, it has been considered be-

14. Report of 29 December 1981 at p. 104.
15. Address of 5 October 1981 before the Tax Society of New York University, reprinted in *Tax Notes,* 12 October 1981, pp. 867, 872.
16. At least 5 bills have been introduced in the Senate and 18 in the House of Representatives which call for repeal of the safe harbor leasing provision.
17. Treasury Decision 7800.
18. *Baltimore Sun,* 10 January 1982, p. A-1.

fore, and is used in some countries, notably in Western Europe, as a means for distributing tax incentives for investment (see box). The major advantage of a refundable credit is that the incentive is more precisely targeted; in other words, the company which is supposed to receive the subsidy receives the whole subsidy, without having to share it with a lessor as under Section 168(f)(8).[19] The difficulty with a refundable tax credit is that it is likely to be politically impossible, particularly at a time of unprecedented deficits, for the Federal government to make cash payments to distressed corporations or profitable corporations, which for one reason or another have no U.S. income tax liability.

Another means of allowing corporations in a loss position to have the benefit of incentives would be to allow them to take advantage of those incentives over an indefinite period of time. This would, however, not be effective in many cases and in any event does not completely address the problem. Net operating losses and certain credits can already be carried over for a period of 15 years,[20] and any incentive that is only available several years down the road is really no incentive at all. The present value of the tax credit or deduction will always be much greater than the value of that same benefit taken several years in the future. That is why tax leasing has proved to be so popular among the lessees. Even after paying a premium to the lessor they still benefit because they receive an infusion of cash immediately. For many companies the promise of a tax benefit in the future means little; they may have disappeared before they are able to use it.

The problem addressed by tax leasing is by no means simple. If Section 168(f)(8) is abolished and nothing is put in its place, the tax incentives offered for capital investment will continue to cause distortions in the economy. However, some distortion is inevitable where the revenue system is too heavily depended upon as a vehicle for carrying out economic programs. Perhaps the real solution is for the Federal government to eliminate tax incentives for investment, which will increase its revenues and decrease its need to borrow money, thereby freeing a substantial amount of capital which would then be available at a lower cost to the private sector.

19. See Bierman and Bierman, "Leasing and the Tax Cut of 1981", *Tax Notes,* 19 October 1981, p. 875.
20. IRC Sections 46(b); 172.

SELECTED INVESTMENT SCHEMES IN EUROPEAN COUNTRIES AVAILABLE WITHOUT REGARD TO TAXABLE INCOME

NETHERLANDS: The Law on Investment Incentives (WIR), effective 24 May 1978, provides for a tax-free basic investment premium and a number of tax-free investment bonuses. (The law replaces two prior special tax incentives for investment: accelerated depreciation and an investment allowance.) The WIR premium and the total investment bonuses are credited against the taxpayer's income tax liability. The depreciable base of the assets concerned is not affected. Corporations operating at a loss may apply to the Tax Administration (Inspecteur der Vennootschapsbelasting) for payment of any excess over tax due. Non-residents may also benefit from these subsidies; however, where it affects their income tax liability, it may also affect the possibility of crediting Dutch income tax against income tax in their home country, e.g. the United States. Therefore, the net result will be no actual benefit from the cash subsidy.

FRANCE: A cash grant (Regional Development Grant) of up to 25% of amounts invested may be obtained by businesses which create or expand activities in designated areas where industrial problems exist.

GERMANY: The Investment Premium Law (Investitionszulagengesetz) provides for a tax-free investment aid of 8.75% of the amount invested in depreciable fixed assets for new businesses and expansion of business in certain development areas. Premiums varying between 7.5% and 20% of the cost of investment in new depreciable fixed assets are available where the assets are used in research and development, production and distribution of energy, and for any purpose where the assets were ordered or production commenced within stated time periods.

The government is presently considering offering a 10% investment grant for investment made during 1982 in new plant and buildings, provided the firm making the investment spends more than its average investment in the past 3 years.

SWEDEN: Investments made during certain stated time periods, in general ending 31 December 1979, were eligible for an investment allowance in the form of a 10% or 25% deduction (prior investment periods have been granted deductions of 20% and 30%) which could only be taken in the year of the investment. However, if the profit was insufficient to offset the entire allowance, the taxpayer could opt to receive cash in the amount of 4% or 10% of the investment.

Tax Incentives of Industrialized Countries for Private Undertakings in Developing Countries

A Brief Introduction

by Eugen Jehle*

I. INTRODUCTION

A. Background

In recent years, world-wide interest in the relationship between industrialized and developing countries has increased significantly. This is last but not least documented in the creation of specific international bodies and organizations that are preoccupied with all possible issues involved, directed to bring about an improvement in the economic and social situations of developing countries.

There is little controversy around the question that tax incentives for private undertakings, on the side of industrialized countries and/or developing countries, are only one device out of a vast variety of possibilities that could make a contribution to a more equitable distribution of wealth amongst nations. Furthermore, the degree of usefulness of such incentives will depend upon a great number of factors, such as the economic system of a developing country and the degree of development that has already been achieved.

B. Scope of this article

As indicated above, the appropriate means of support for developing countries are often difficult to identify. This article will present a short survey of possible tax incentive measures open to industrialized countries. It is quite clear that this catalogue of measures is only one component of a broader picture that, to be somewhat comprehensive, should also include *tax incentives provided by developing countries* and *the reconciliation of tax incentive measures as provided by industrialized and developing countries*.

Nevertheless, this article is confined to tax incentives for private undertakings in developing countries provided by industrialized countries. Indeed, it can be observed that there is renewed interest for this especially on the side of the industrialized countries these days for which one can assume the following reasons:

(1) the gloomy state of the economy of many industrialized countries themselves, documented by huge budget deficits, great balance of payment problems, etc., makes it very difficult for the respective governments to maintain or even increase the transfer of public funds to developing countries;

(2) the discovery of possible potential for economic growth through private undertakings in developing countries that may be beneficial to the developing country as well as to the economy of the industrialized country; i.e. where it is possible to support undertakings in developing countries that further economic development and employment opportunities there without representing a threat to the economic situation in the industrialized country, for example with respect to the unemployment question. This scheme will be of particular interest where financial facilities can be made available from third countries. As opposed to the direct transfer of financial facilities, tax incentives often do not cause an immediate outflow of public funds.

Contents

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There are certainly many more reasons but, at present, these two appear to be the most significant.

This short presentation of the most common tax incentive measures will basically refer to private undertakings such as participation in a corporation, investment by way of a permanent establishment, the granting of loans, and the transfer of technology. It mainly applies to taxes on income. Another important issue, namely, tax incentives for expatriates, will only be briefly mentioned.

C. General problems

The types of tax incentives that can be employed will often be a function of the tax systems that are applied in the countries involved. For instance, where an industrialized country applies the territoriality system, the consequences will be quite different vis-à-vis another industrialized country that applies a world-wide system of income taxation.

Another crucial point is the fact that it is, in theory, a generally accepted idea that the investor should benefit from a tax incentive granted by a developing country and not the tax authority of the industrialized country of which he is a resident; however, some systems may well eliminate any such efforts taken by developing countries.

A further problem area constitues the existence of different accounting systems for tax purposes in the countries involved.

In some cases, the measures to be discussed below can provide a solution, but others remain outside the scope of this article.

II. THE DIFFERENT TYPES OF TAX INCENTIVES*

A. Classification

The tax incentives that may be made available to industrial countries can be classified in different ways, for instance as capital-related or income-related incentives, as incentives classified according to the stage of a private undertaking at which they are available, and many more. Of course, the type of incentive will also depend on the type of the activity that is undertaken.

Furthermore, the granting of tax incentives and the availability of measures for the avoidance of double taxation are often closely interrelated. Indeed, those measures can themselves represent incentives and therefore they are here given the same attention as are "ordinary" tax incentives although there are, of course, arguments to take a different viewpoint.

This short survey follows mainly the "stage classification".

B. Pre-activity/Initial tax incentives

Under this category those tax incentives are listed that can be made available either in the planning period (see (1)) or at the time the undertakings are initiated (see (2) to (5)).

1. Future investment reserves

Future investment reserves are amounts that are deductible from taxable income before any undertaking in a developing country has been started.

The maximum amount deductible may be determined as a certain percentage of the taxable profit of a given year, as a specific fixed amount, or may be based upon any other assessment base (equity capital, etc.). The future investment reserve as created must result in an undertaking in a developing country within a specified period of time; otherwise the amounts deducted from taxable income must be added back and are subject to taxation at the normal rate. The amount of the reserve may either be "kept" within the enterprise or it may be required to be transmitted to an institution such as a national development company or development bank. The latter way could also provide access to additional funds, expertise, etc. at the time an undertaking is planned and started.

The future investment reserve provides a possibility to enterprises, particularly small and medium sized enterprises, to "prepare" themselves financially for ventures in developing countries which are already at the planning stage. It appears that the possibility to build up such a reserve would open the way to private undertakings in developing countries for enterprises that may otherwise be prevented from doing so.

With respect to domestic investment, the future investment reserve scheme has been applied in a number of countries, including Denmark,[1] Finland[2] and Sweden[3] for some time. A scheme with a similar effect, namely, pre-investment depreciation, is, for instance, employed in Norway.[4]

2. Valuation rebate

Upon investing a certain amount of capital in an undertaking, a "lump sum depreciation" of a certain percentage may be granted without the requirement that there actually be a drop in the value of the underlying item. By way of such a valuation rebate, a hidden reserve is created which need not be dissolved until the undertaking is disposed of. The effect of this measure is a tax saving in the initial year of the undertaking with no tax consequences in the following years. The advantage of this measure is the easy handling, i.e. there is no substantial bureaucracy involved.

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* Specific country references to various kinds of incentives and other measures have been established with the kind cooperation of the Staff of the International Bureau of Fiscal Documentation.
It must be noted that the references to specific countries are to serve as examples only and naturally cannot represent any kind of complete survey.

1. Law on Investment Reserve, of 18 November 1975, as amended.
2. Law on Investment Reserve and Allowance, of 28 December 1978, as amended.
3. General Investment Reserve Act, of 31 May 1979, as amended. For a detailed discussion of the Swedish scheme, see:
(a) Claessen, F.M., "General Investment Reserve – New Provisions", in 20 *European Taxation* (1980) 12 at 389.
(b) Norr, Martin, *Reserves for future investment: a Swedish Tax Incentive*, Vol. I of Selected Monographs on Taxation (Harvard Law School International Tax Program and the International Bureau of Fiscal Documentation, 1974).
4. Income and Net Worth Tax Act, Section 44A, Lit. 4b and 5b.

The valuation rebate was, for instance, granted in West Germany under the Development Aid Tax Law, but was abandoned on the occasion of a later amendment of that law. The tax law of Austria contains a similar provision for investment abroad provided that certain requirements are met.[5].

3. General reserve

A "general reserve" is described in this article as a profit-deductible amount based upon the value of a private undertaking initiated in a developing country. The deduction of the reserve will usually take place in the year in which the underlying undertakings are being started. As to the amount of the reserve, there are numerous possibilities ranging from a rate of 1% to a rate exceeding 100%.

Another determinant of this type of incentive is the time period for which it is granted. The possibilities range, of course, from a dissolution at the time the undertaking is being disposed of to a dissolution within a relatively short period after its creation. In between there are many ways, for instance a dissolution in annual installments after a grace period of several years. The effect of this measure is basically a tax respite, the extent of which depends on the period during which the reserve may be maintained.

Provisions for a general reserve for undertakings in developing countries are contained in the tax laws of France,[6] Japan[7] and West Germany.[8]

4. Tax-free transfer of hidden reserves

The tax systems of most industrialized countries provide for the taxation of hidden reserves upon dissolution, either by way of capital gains taxation or by way of automatic inclusion of such amounts into profits due to the application of the accrual method. A dissolution of hidden reserves is usually assumed when an asset is sold or otherwise leaves the sphere of an enterprise (or country).

"Bearers" of hidden reserves may be all kinds of movable fixed assets but also intangible assets such as patents, trademarks, etc. In the latter case, the amount of hidden reserves may be particularly great when the underlying items represent the result of own research and development efforts and the tax law of the country in question does not require/allow the capitalization of the underlying costs. Indeed, the obligation to dissolve hidden reserves can frustrate the otherwise desirable transfer of assets to undertakings in developing countries. This effect can be avoided in allowing enterprises to maintain the book value of such items (in case it remains in the sphere of the enterprise). Where self-developed, non-capitalized intangible assets are being transferred, a solution may also be found in capitalizing the item with one unit of account (as pro memoria item). At any rate, where an industrialized country does not want to waive the right to tax the hidden reserves of items upon the transfer to a developing country, it could allow a combination of dissolving the hidden reserves with the creation of profit-deductible reserves.

In the first case, a tax-free transfer of hidden reserves would be the result whereas in the latter case (profit-deductible reserve) the consequence will depend upon the requirements with respect to the dissolution of those reserves. If the reserve may be maintained indefinitely, a generous tax respite will be the consequence whereby this transaction even may become a tax-free transfer (e.g. where a patent eventually expires).

5. Investment premiums (Investment tax credit/Cash grant)

A special form to promote private undertakings in developing countries is the investment premium to be granted by the authorities of the industrialized country.

There are arguments that this type of incentive need not necessarily be regarded as a tax incentive. In this article, however, it is being dealt with as a tax incentive; the only difference vis-à-vis other incentive measures is to be seen in the fact that the implications do not appear at the level of income but rather at the level of amount of tax due. The basic idea is that a private undertaking in a developing country will benefit from a premium (investment tax credit or cash grant) calculated as a certain percentage of, for instance, capital invested.

The advantages of investment premiums include the quick availability of liquidity for the enterprise. Furthermore, if the investment premium does not influence the acquisition cost to be used for possible depreciation and is also otherwise kept outside the accounting system for tax purposes, it is truly a one-time affair that does not encourage the blossoming of red tape.

At any rate, this type of incentive has become a popular incentive measure for domestic investment in a number of countries, including Canada,[9] the Netherlands,[10] Spain,[11] West Germany[12] and the United States of America.[13]

C. Tax incentives during operation

The pre-activity/initial tax incentives are mostly concerned with tax matters that arise at the first stage of an undertaking in a developing country, whereas the tax incentives during operation are mostly concerned with the outcome of those undertakings in subsequent years, i.e. the treatment of income – positive or negative – is the major issue.

Again it must be emphasized that precise answers to related questions will depend on the tax system of a specific industrial country; if the territoriality principle of taxa-

5. Einkommensteuergesetz, Sec. 6(7).
6. CGI, Article 39 octies A loi no. 80-30 du 18.1.80.
7. "Overseas Investment Loss Reserve." For a detailed discussion, see: *Guide to Japanese Taxes,* Yuji Gomi 1981-82, at 332.
8. Entwicklungsländer – Steuergesetz, of 21 May 1979. For a detailed discussion of West German legislation in this context, see: Jehle, E., "The New Developing Countries Tax Law – Tax incentives for West German investments in the third world", 19 *European Taxation* (1979) at 349. As of 1 January 1982, this law has been repealed.
9. Income Tax Act, Sec. 127(5)-(12).
10. For instance: Law on Investment Incentives (WIR), of 24 May 1978.
11. For instance: Law 61/1978 of 27 December 1978, Impuesto sobre Sociedades, Article 25, as updated.
12. Investitionszulagengesetz, of 2 January 1979.
13. IRC, Secs. 38 and 46.

tion is employed, the answers are different as compared with countries that adhere to the taxation of world-wide income.

In this context, there is, of course, another important issue, namely, the question as to how a developing country taxes private undertakings carried on by foreigners. Indeed, this is not the subject of this article but the underlying implications cannot be totally ignored. Thus, it will be necessary to mention briefly relevant measures.

One could argue that measures for the avoidance of double taxation, both unilateral and bilateral, are not by their very nature tax incentive measures of industrialized countries for private undertakings in developing countries, since, to a great extent, they are also employed in relationships between industrialized countries. However, whatever viewpoint one may employ, these measures are too important to be neglected and their implications may have a greater significance for a foreign investor than the aggregate of all other tax incentives. Furthermore, there are indeed measures that are uniquely designed for the relationship between an industrialized country and a developing country.

1. "Specific" tax incentives

In this article, those measures are defined as "specific" tax incentives (during operation) which usually do not fall under the category of measures for the avoidance of double taxation.

a. *Special depreciation*

A great number of industrialized countries provide a rather generous tax regime by way of allowing a fast depreciation of fixed assets. Although that regime is usually designed for domestic purposes it may nevertheless be applicable with respect to undertakings in developing countries, namely where such an undertaking is carried on as a permanent establishment and the system of taxation of world-wide income is applied.

The most common schemes are the following:

- *Full depreciation* for fixed assets in the year of acquisition. This regime is, for instance, applied in the Republic of Ireland[14] and in the United Kingdom;[15] other countries are also reported to be considering the introduction of this scheme into their tax system.
- *Accelerated depreciation,* i.e. a fast writing off of fixed assets by way of allowing high depreciation rates in initial years or an additional depreciation on top of the usual depreciation that is based on the useful life of an asset. At any rate, the depreciation base usually does not exceed 100%. This scheme is common practice in many countries, including Austria,[16] Belgium,[17] Japan[18] and Sweden[19] whereby there are often restrictions with respect to the specific type of fixed assets that are required.
- *Depreciation allowance,* i.e. the depreciation base exceeds the acquisition costs of a fixed asset. This scheme is, for instance, found in Belgium[20] and Finland[21] whereby it is also often restricted to specified types of assets or certain areas.

b. *Reserves for losses*

Where an undertaking in a developing country is maintained in the form of a subsidiary company or where a tax treaty provides for the exemption from taxation of income of a permanent establishment in the industrial country, no consideration of losses of such undertakings will usually be provided.

As an incentive measure, an industrialized country may include a provision in its national tax law that allows the creation of a profit-deductible reserve for such losses. Usually, such a reserve is dissolved as soon as the subsidiary company/permanent establishment operates at a profit.[22]

Generally speaking, the consideration of such losses is, for instance, possible in the international relationship in France,[23] West Germany[24] and the Netherlands[25] provided that certain preconditions are met.

c. *Depreciation to fictitious going concern value*

The tax laws of some industrialized countries provide the possibility of depreciation in those cases where the taxpayer can establish that the actual value of an asset is lower than its book value. This scheme may be opened for application for undertakings in developing countries on a fictitious basis. A systematic depreciation of a certain annual percentage of the initial investment spread over a number of years down to a certain fictitious going concern value without requiring economic justification represents an attractive possibility to provide a tax incentive for private undertakings in developing countries in that it allows the tax-free creation of hidden reserves. This scheme offers a "compensation" for the general risk that is always involved where there are undertakings in remote countries.

d. *Tax reliefs for expatriates*

Although it will usually be the developing country that taxes expatriates from industrialized countries employed in undertakings there, there are nevertheless certain situations where an industrialized country can provide reliefs for such persons. This is particularly true where an industrialized country bases its tax system upon citizenship; in this case, a substantial basic exempt amount can bring about the necessary incentive to work in a developing country.

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14. Finance Act 1971, Sec. 26, as amended.
15. Finance Act 1972, Sec. 67.
16. Einkommensteuergesetz, Sec. 8.
17. For instance: Law of 30 December 1970 regarding economic expansion.
18. Japan allows accelerated depreciation for a great variety of assets. For a detailed discussion, see: *Guide to Japanese Taxes,* Yuji Gomi 1981-82, at 316 ff.
19. For instance: Regulations to Sec. 29 of the Local Tax Act.
20. For instance: Income Tax Code, Art. 48 bis (introduced by Law of 10 February 1981).
21. For instance: Law on incentives for investments in certain regions, of 31 December 1975, as amended.
22. For a detailed discussion on the effect of losses in one country on the income tax treatment in other countries of an enterprise or of associated enterprises engaged in international activities, see: *IFA – Cahiers,* LXIVb, 1979.
23. For instance by way of:
    - CGI, Article 39 octies A loi No. 80-30 du 18.1.80.
    - CGI, Article 209 quinquies.
24. Auslandsinvestitionengesetz of 18 August 1969, Secs. 2 and 3.
25. Implied in the Dutch system of taxation of world-wide income (general rule).

Relief measures in this context may also be extended to the social security system of the industrialized country; for example, where it appears to be desirable for an expatriate to remain in the social security system of his home country, this should be facilitated in the underlying legislation.

2. Tax incentives provided by measures for the avoidance of double taxation

Measures for the avoidance of double taxation can be based on (a) unilateral provisions of the national law, (b) bilateral treaties between two states, or (c) multilateral treaties between a number of states.

For the purpose of this article, i.e. the application of such measures as tax incentives in the relationship between developing and industrialized countries, only the unilateral and the bilateral approaches are significant.[26]

This article does not deal with those two legal approaches as such but with the methods that, in principle, may be offered by both.

The following is a presentation of different methods for the avoidance of double taxation with respect to taxes on income whereby the situation is, of course, regarded from the angle that a person (investor) in an industrialized country receives income from an undertaking in a developing country. (To some extent, these principles are also applicable to taxes on capital.)

Again, the discussion of the various methods basically refers to private undertakings in the form of subsidiary companies, permanent establishments, the granting of loans, and the provision of technology (royalties), as the case may be (see also above).

a. *Tax exemption method*

The exemption method actually "ignores" the income that arises abroad (source country), in this case a developing country. In other words: the source country will tax the underlying income according to its tax laws whereas the investor's home state (industrialized country) does not levy any taxes on the same income item. Thus, such income is tax free in the investor's home country.

This method makes sure that tax incentives granted by developing countries fully benefit the investor. As a general rule, tax incentives are granted by a developing country as a compensation for, for instance, an insufficient infrastructure. Thus, the tax exemtpion method enables an investor to operate under more difficult circumstances, usually under the same conditions as similar undertakings in a developing country. In this context, the exemption method is most relevant with respect to taxation of the profit of a permanent establishment; the tax exempt-status may either be based on a unilateral waiver of the investor's home country or on a tax treaty provision that allocates the exclusive right to tax to the state where the permanent establishment is located.

This method can thus be regarded as a simple but powerful incentive to carry on undertakings in a developing country (provided, of course, that the "tax climate" there is "pleasant").

A certain "sophistication" of the tax exemption method can be seen in the application of the so-called progression clause. This is to say that a country may well accept the right of another state to tax a certain item but nevertheless employ that tax rate for the (domestic) income that is applicable to the total income (i.e. including the tax exempt income). This measure is of course only relevant where the tax is levied at progressive rates.

Generally speaking, the tax exemption method is unilaterally applied, in different variations (e.g. depending on the type of income) in countries including Australia,[27] France[28] and the Netherlands.[29] Many countries refer to the tax exemption method in their respective tax treaties.

b. *International affiliation privilege*

The international affiliation privilege is a special form of tax exemption method for intercompany dividends. Where a corporation that is a resident of an industrialized country holds a certain percentage of the equity capital of a corporation in a developing country, the dividends paid by the latter to the former are tax exempt in the industrialized country.

As to the percentage necessary to qualify for this favorable tax treatment, there is no uniform picture. Some countries require a stake of at least 25% in the capital of the subsidiary company, others are satisfied with 20, 10, 5 or an even lower percentage rate. At any rate, the decisive criterion is often whether the parent company can exercise some influence on the subsidiary company by virtue of the shareholding.

An extension of this favorable treatment can also be considered in those cases where the shareholder is not a corporation but, for instance, a partnership. In many cases if may be desirable or even vital to carry on undertakings in a developing country in the form of a corporation whereas, it may be favorable to carry on business in the home country in a legal form other than a corporation.

This incentive measure is, for instance, unilaterally applied in Australia,[30] Belgium,[31] France,[32] the Netherlands[33] and Switzerland,[34] other countries referring to it in underlying tax treaties.

c. *Fictitious tax credit (Tax sparing credit/Matching credit)*

The currently fashionable method for the avoidance of double taxation with regard to the relationship between industrialized and developing countries is the fictitious tax credit.

Basically, the idea is that an industrialized country grants

26. For a more detailed discussion of this subject, see for instance:
(a) *The Taxation of Companies in Europe, Guides to European Taxation*, Vol. II.
(b) "Unilateral Measures to prevent double taxation". *IFA – Cahiers*, LXVIb, 1981.
27. Income Tax Assessment Act, Sec. 23(g).
28. Implied in the French system of territoriality taxation.
29. Decree of 7 April 1965 (unilateral relief measures, Articles 3 and 7).
30. Income Tax Assessment Act, Sec. 46.
31. Income Tax Code, Articles 111-113.
32. CGI, Articles 145, 146(2) and 216.
33. Corporate Income Tax Law, Article 13.
34. Art. 59 Wehrsteuerbeschluss.

a tax credit of a certain percentage for underlying income from a developing country without regard to how high or low (e.g. due to special tax incentives) the actual tax burden of that income has been in the developing country. Therefore, this mechanism is named the "fictitious tax credit", also referred to as tax sparing credit and matching credit. The income items for which it is usually employed are dividends, interest and royalties.

This method may be further refined. The most important approaches can be summarized as follows:
(i) the credit in the industrialized country equals precisely the tax ordinarily provided for in the developing country. Thus, any incentives that lower the ordinary tax burden are "spared" and benefit the investor;
(ii) the credit in the industrialized country intentionally exceeds the tax levied in the developing country.

Indeed, an almost unlimited number of variations can be designed. Many factors must be taken into consideration; the relevance of this is reflected by the fact that the fictitious tax credit is usually arranged for in bilateral treaties for the avoidance of double taxation where a reconciliation of the diverging factors – due to different tax systems, etc. in the industrialized and developing country involved – will be striven for. It is due to these difficulties that the fictitious tax credit has been employed as a unilateral measure for the avoidance of double taxation only in exceptional cases.

Indeed, many industrialized countries accept the inclusion of the fictitious tax credit (tax sparing credit) into tax treaties with developing countries. The unilateral granting of the fictitious tax credit is not very common; West Germany for instance is prepared to grant it in specific circumstances.[35]

d. *Lump sum settlement*

The application of an accounting and tax system in a specific developing country that differs totally from that in a specific industrialized country may be one out of many possible reasons that it does not appear to be advisable to employ one of the usual measures for the avoidance of double taxation but rather rely on taxation on a lump sum basis.

Again, a great variety of possibilities is available. For instance, one of the most efficient (and least bureaucratic) manners will be a situation where, in the case of a foreign permanent establishment, an industrialized country totally neglects the (foreign) calculations of income and taxes and applies a certain, usually low, tax rate on a possibly estimated (gross) income.

Another popular candidate for taxation on a lump sum basis can be income from personal services in the case of expatriates where the industrial country retains the right to tax but where a fair fixing of deductible expenses encounters great difficulties.

At any rate, the lump sum settlement will represent an attractive "tax incentive" where there is a striking disproportion between the actual amount of income and taxes and the effort in calculating income and taxes according to "well established principles".

e. *Direct tax credit*

The direct tax credit is a logical consequence of the strict application of the principle of taxation of world-wide income (or capital) in that it provides for the deduction of foreign taxes from the domestic tax liability that has been established on the basis of world-wide income (or capital).

Indeed, this measure for the avoidance of double taxation can only be regarded as a tax incentive if one regards the absence of other measures (or less favorable measures) as the only alternative.

Generally speaking, in applying the direct tax credit, the tax burden on income that thas been derived in a developing country will be equal to the tax burden on income that has been earned in the industrialized country of which a potential investor is a resident. Any tax incentive (low tax rate, etc.) provided by the developing country is cashed in by the tax authority of the industrialized country.

Thus a developing country may actually be forced to levy taxes at a high rate although the "economic environment" (poor infrastructure, etc.) makes it highly advisable to promote economic development with taxes that offer a low burden. This can have a particularly adverse impact where the interest of foreign investors is confined to a few specific fields (e.g. oil exploration) and less attractive (foreign) investment in other fields of vital importance is thus frustrated.

Within the method of the direct tax credit, there are also certain possible variations.

For instance, if the so-called per country limitation is applied, income and creditable taxes are established separately for each country. Thus, if there is income from two foreign countries whereby the tax burden of the first is lower than that of the industrialized country but the second is higher, the difference will be cashed in by the tax authority in the first case but in the second case the excess (tax burden developing country – tax burden industrialized country) may not be creditable but must be borne by the investor.

Where, however, the overall limitation is applied, income and creditable taxes are established as an aggregate and there is an inter-country compensation whereby a non-creditable residual tax burden appears only in those cases where the average tax burden of foreign-source income exceeds the tax burden of the industrialized country in question.

Another possible procedure is the limitation of the tax credit to specific types of income, i.e. the strict application of a schedular system of taxation in an international relationship.

The provision of a "carry-forward of foreign taxes" can offer some relief in those cases where the taxpayer in the industrialized country has no tax or an insufficient amount of tax to be credited against the foreign tax.

35. Körperschaftsteuergesetz, Sec. 26(3).

The direct tax credit is, for instance, the method that is generally applied in Denmark,[36] Finland,[37] Japan,[38] West Germany,[39] Sweden,[40] United Kingdom,[41] and the United States of America.[42]

It is observed that some countries which usually do not grant the direct tax credit – either because they employ the territoriality system or their tax system does not provide for measures for the avoidance of double taxation – are prepared to grant it in the case of income received from developing countries. For instance, the Netherlands allow the direct tax credit for withholding taxes paid on dividends, interest and royalties provided they stem from developing countries.[43]

f. *Indirect tax credit*

The term "indirect tax credit" is usually referred to in cases where foreign taxes (e.g. paid in a developing country) may be credited against taxes in an industrialized country whereby the taxpayer of the foreign taxes is, from a legal point of view, not identical with the taxpayer that claims a credit for the foreign taxes paid.

The practical relevance of this incentive measure is generally confined to dividends. Where a parent company in an industrialized country receives dividends from a subsidiary company in a developing country, the availability of the indirect tax credit will allow a credit of the income tax paid by the subsidiary company against the tax liability of the parent company, on a proportional basis of course.

Thus, there is generally no difference in the tax burden between capital invested in a developing country and at home in an industrialized country (see above, direct tax credit).

The indirect tax credit is, for instance, available in Japan,[44] West Germany,[45] United Kingdom[46] and the United States of America.[47]

g. *Deduction of foreign taxes from the taxable base*

Generally speaking, this type of tax measure usually can be regarded as an incentive for undertakings in developing countries only in cases where there is otherwise no relief measure at all.

Nevertheless, depending on a number of other factors, this method can be favorable. For instance, where an investor suffers losses in the industrialized country and there is no carry-forward of foreign tax credits, this method may at least safeguard a carry-forward of losses whereby the foreign taxes are included in the relevant amount.

Furthermore, the possible application of this method in cases where other measures cannot be used may bring about some relief, e.g. where foreign taxes are not regarded as being equivalent to domestic taxes and a tax credit is therefore refused.

West Germany[48] and Japan,[49] for instance, offer their taxpayers an option between deduction of the foreign tax from income and a tax credit.

D. Tax incentives upon termination of activities

1. Tax-free re-transfer of hidden reserves

Where a private undertaking in a developing country is successfully terminated (e.g. the expiration of a joint venture carried on as a corporation, the disposal of a permanent establishment, the repayment of a loan, etc.), hidden reserves may have been generated.

To the extent that a possible taxation of those hidden reserves falls under the jurisdiction of an industrialized country, this country may consider the possibility to transfer hidden reserves as contained in such items into a new private undertaking in a developing country.

2. Tax reliefs for returning expatriates

Although this subject does not actually fall within the scope of this article, it should nevertheless be mentioned that there is a number of possibilities to make temporary work in developing countries attractive for executives, technicians, etc., last but not least by way of specific tax incentives and/or by generous treatment generally provided by in the tax system for such cases.

E. Summary

Many factors will influence the decision as to which type of incentive is to be granted for what type of undertaking. Indeed, each industrialized country has to design its own "package" of incentive measures that takes into consideration all relevant factors of taxation and groups them in a consistent manner. The table below provides a simplified survey as to which measures for the avoidance of double taxation may be offered by the tax system of an industrialized country.

III. CONTROL MECHANISMS

The possibilities for the tax authorities of an industrialized country to exercise control over private undertakings abroad are naturally limited. Indeed, they will generally be confined to the assistance of the tax authority of a developing country, as it may be arranged by virtue of a tax treaty under the "exchange of information clause".

Where the availability of a specific tax incentive of an in-

36. Assessment Law, Sec. 33.
37. Tax Credit Law, of 22.5.1981.
38. Income Tax Law, Article 95, Corporation Tax Law, Art. 69, Local Tax Law, Arts. 53 and 321-8.
39. Einkommensteuergesetz, Sec. 34c, Körperschaftsteuergesetz, Sec. 26.
40. National Income Tax Act, Secs. 24-27.
41. Income and Corporation Taxes Act 1970, Sec. 498.
42. IRC, Sec. 901.
43. Decree of 7 April 1965 (Unilateral relief measures, Art. 3a).
44. Income Tax Law, Article 95, Corporation Tax Law, Article 69, Local Tax Law, Arts. 53 and 321-8.
45. Körperschaftsteuergesetz, Sec. 26(2).
46. Income and Corporation Taxes Act 1970, Sec. 498.
47. IRC, Sec. 902.
48. Einkommensteuergesetz, Sec. 34c(2), Körperschaftsteuergesetz, Sec. 26(6).
49. Supra footnotes 18 and 38.

Type of incentive \ Type of activity	(1) Subsidiary company (inter-company dividends)	(2) Permanent establishment (profits)	(3) Portfolio investment (dividends)	(4) Granting of loans (interest)	(5) Provision of technology (royalties)
(a) Tax exemption method		X	0	0	0
(b) International affiliation privilege	X				
(c) Tax sparing credit (matching credit)	X	0	X	X	X
(d) Lump sum settlement	0	X	0	0	0
(e) Direct tax credit		X	X	X	X
(f) Indirect tax credit	X		0		
(g) Deduction of foreign taxes from taxable income		0		0	0

X = application is common practice   0 = application (if at all possible) is not common

dustrialized country will depend upon the fulfillment of certain requirements (e.g. the maintenance of "active" undertakings in industry, commerce or agriculture), a confirmation certificate of a chartered accountant firm or a Chamber of Commerce (possibly one in which the country is a partner) may be a possible means to exercise a certain control especially concerning tax incentives that are granted at the initial stage of an undertaking.

IV. FINAL REMARKS

Tax incentives provided by industrialized countries for private undertakings in developing countries can only support the efforts of the latter's governments to accelerate the pace of the improvement in the economic development of their countries. However, it is and should remain a passive role; the active part in this relationship must be played by the developing countries themselves. As far as taxation is concerned, it is the task of the repective governments to create a tax climate and design an investment policy that make it attractive for foreigners to take the risk that is always involved in starting entrepreneurial undertakings, particularly in geographically remote areas.

At any rate, it has been observed that a great number of industrialized countries offer an attractive package of tax incentives for undertakings within their boundaries. The extension of such provisions to undertakings in developing countries is certainly one of the available possibilities; this is particularly true were an industrialized country employs the system of taxation of world-wide income but confines certain incentive measures (e.g. investment premiums) to domestic investments.

Anyhow, it is difficult to evaluate the positive impact that tax incentives may have, those of developing countries and of industrialized countries; the general feeling is that one must not overestimate their significance. However, it is even more difficult (or extremely easy?) to evaluate the negative impact that excessive tax claims and the possible absence of reasonable reconciliation measures do have, i.e. how many private undertakings that would be economically viable and that could contribute a great deal to the development of available resources never leave the stage of a feasibility study for tax reasons?

Quite a number of efforts are being undertaken to bring about an improvement in this respect. But there are good reasons for the assumption that the simplicity and reasonableness of tax provisions have much greater positive consequences in the development process of an economy than supposedly "sophisticated" solutions.

Finally, it must again be stated that private undertakings are just one element in the great complex that is identified as the relationship between industrialized and developing countries, and tax incentives are only a small portion of that element. Indeed, there is no pat solution for the improvement of this relationship. Rather, it is necessary to elaborate individual solutions for the specific cases of individual countries.

SWEDEN:

Budget 1982–83

> *Swedish tax has been dealt with in the Bureau's publications:* Supplementary Service to European Taxation, *Sections A and B;* Guides to European Taxation, *Vol. II:* The taxation of companies in Europe; *and Vol. IV:* Value added taxation in Europe.

The Swedish Ministry of Economic Affairs and the Ministry of the Budget recently published a 168 page booklet entitled: *The Swedish Budget 1982/83.*

We reproduce below the pages dealing with taxation.

One of the main foundations for the estimation of Budget revenue is a forecast by the National Audit Bureau. In fiscal 1982/83 revenue is calculated to about 169 billion kronor.

The main revenue items are presented below. The estimates are based on the assumptions which have been adopted in the Economic Policy Statement.

Budget revenues. Billion kronor; estimated

	1981/82	*1982/83*	*Change*
Taxes on income, caital gains and profits	31.8	34.7	+2.9
Statutory social security fees	31.0	31.0	–
Property taxes	2.7	3.4	+0.7
Value-added tax	38.2	40.5	+2.3
Other taxes on goods and services	29.2	30.5	+1.3
Revenue from central government activities	17.5	18.2	+0.7
Other revenue	9.0	10.7	+1.7
Total revenue	159.4	169.0	+9.6

The revenue from taxes on **income, capital gains and profits** comes very largely from the state tax on personal income.

The present system

For individuals, state income tax is levied on a progressive scale. For the 1982 income year the rate ranges from 2% in the lowest taxable bracket (6,900–27,600 kronor) to 58% in the highest (above 207,000 kronor). The scale is indexed against inflation in that the brackets are adjusted annually to allow for price developments. As of 1982 allowance for prices is made excluding indirect taxes (incl. VAT), customs duty and charges, while an addition is made for subsidies. Changes in energy prices are disregarded, too.

There is also a local tax on income. This is levied at a proportional rate, which is decided by each country council and municipality. For 1982 the average rate is calculated to be 29.74%. A marginal tax ceiling operates to prevent the combined rate of state and local income tax from exceeding 85% in the highest income bracket and 80% below this.

For tax purposes an important concept is the *source of income*. Certain costs are deductible from each source's taxable receipts and the net result is entered as income or a deficit under one of the six sources or types of activity (employment, capital, real property excl. agriculture, business, agricultural property, and incidental). For assessment purpose the taxable receipts and deductible costs are computed separately for each source. The sum of the sources which show a surplus then constitutes *total income.* From this are deducted any deficits on other sources, other general deductions and any deduction for losses. What remains is *assessed income.* Tax is however calculated on *taxable income,* which in most cases equals assessed income (for local tax there is a further general deduction). Certain persons, chiefly those with a basic pension, are entitled to an extra deduction from assessed income. Final tax is then calculated with allowance for any tax reductions. For 1982 tax reductions are available for married persons whose spouse has little or no income, for single persons with a child living at home, and for certain forms of saving and share dividends.

For 1982 state tax is smaller than local tax on incomes up to around 171,700 kronor.

Total revenue from state tax on personal income is estimated at 27.1 billion kronor in fiscal 1982/83.

Companies pay state income tax at 40% of taxable income. The rate for economic associations is 32%. State tax revenue from these legal entities in fiscal 1982/83 is estimated at 5.8 billion kronor.

Besides the tax paid by individuals and legal entities on income, capital gains and business, this main revenue item includes several minor headings. Total revenue under this item is accordingly estimated at 34.7 billion kronor.

Proposed change to income tax

In the spring of 1981 the Centre, Liberal and Social Democrat parties agreed on a reform of income tax and the intention is to present a Bill to Parliament this spring. The proposed reform involves a marked reduction of marginal tax rates and restrictions on the tax value of deficit deductions. The reform is to be implemented over three years, starting with the 1983 income year. When it is fully operational, the marginal tax rate for most full-time employees will not exceed around 50%. At the same time, the tax value of deficit deductions will be limited to about 50% of the amount deducted, even for persons whose income incurs a marginal tax rate of more than 50%.

The reform is confined to state tax, i.e. it does not concern local income tax. Moreover, the new regulations apply only to individuals and others for whom state income tax is progressive.

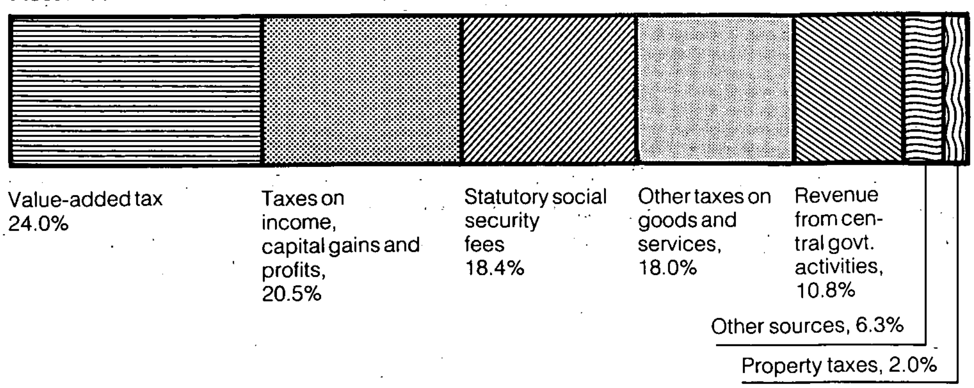
The tax agreement states that the reform should be financed in full by raising payroll charges or by means of a wider tax on factors of production.

In the present Draft Budget tax revenue has been forecast on the basis of unchanged tax regulations. The proposed reform's effects on the Budget are to be elucidated in this spring's Supplementary Budget Bill.

The item **statutory social security fees** comprises all charges that are calculated as a percentage of the wagebill and paid by employers and the self-employed. For 1982 there are 11 charges of this type. The revenue from them is accounted for in several ways; some are included in full in the Budget, others only partly or not at all. Those included in full – the charges for basic pensions, child care and adult education – are calculated to yield 31.5 billion kronor in fiscal 1982/83. Due to the construction of certain funds, the yield from the other charges is estimated to reduce Budgetary revenue by 0.5 billion kronor.

Total revenue from statutory security fees in fiscal 1982/83 is estimated at 31.0 billion kronor.

Sources of revenue
Fiscal 1982/83



The main **property taxes** are those on capital, inheritances and gifts, and stamp duty.

For individuals, capital tax is progressive and starts at 1% on wealth between 400,000 and 600,000 kronor, rising to 2.5% on wealth above 1.8 million kronor. In fiscal 1982/83 capital tax is estimated to yield 0.9 billion kronor.

Total revenue from property taxes in fiscal 1982/83 is calculated to be 3.4 billion kronor.

Value-added tax (VAT) is levied as of 16 November 1981 at 17.7% of the taxable value (21.51% of the pre-tax price). Certain goods and services are partially or wholly exempt from VAT. Revenue from VAT is the largest individual item on the revenue side of the Budget. In 1982/83 it is estimated at 40.5 billion kronor.

Other taxes on goods and services are e.g. those on road traffic, petrol, spirits, wine, tobacco and energy. Revenue from this group in 1982/83 is estimated to total 30.5 billion kronor.

Road traffic taxes and petrol tax are calculated to yield about 9.4 billion kronor in 1982/83.

Petrol tax is levied on petrol and other motor fuels containing at least 70% petrol by weight, as well as on certain alcohols and alcohol extracts that are intended as motor fuel. The tax on petrol is to be increased to 1.20 kronor per litre as of April 1982.

Road traffic taxes are levied on vehicles and kilometreage. The vehicle tax is based on the vehicle's weight. The kilometre tax is charged if the vehicle is fitted to run on fuels other than petrol and liquefied petroleum gas, i.e. chiefly diesel oil. This tax varies with the vehicle's type and weight; it is levied on the number of kilometres driven (rounded down to the nearest ten).

Taxes on wines and spirits consist of a basic duty plus a percentage rate. The basic duty on spirits is a variable amount per litre, depending on the alcohol content, while for wine it is a constant amount per litre; the percentage rate is related to the price. Revenue from these taxes in fiscal 1982/83 is estimated to total 5.5 billion kronor.

Tobacco tax is levied by weight. In fiscal 1982/83 it is calculated to yield 2.9 billion kronor.

Energy taxes are levied at the following rates:

Petrol	0.34 kronor/litre
Liquefied petroleum gas	0.53 kronor/litre
Electricity	0.04 kronor/kilowatt-hour (0.03 for certain consumers)
Coal	12 kronor/tonne
Coke, incl. brickettes	14 kronor/tonne
Lignite brickettes, duff, etc.	6 kronor/tonne
Heating and fuel oil	253 kronor/m³

The total yield from energy taxes in fiscal 1982/83 is estimated at 7.9 billion kronor.

Customs duties are levied as a rule as a percentage of the article's dutiable value. A free trade agreement between Sweden and the EEC has been in force since the beginning of 1973. Duty-free trade had been introduced for most of the goods in question by mid-1977. In fiscal 1982/83 customs duties are estimated to yield 1.6 billion kronor.

Revenues from other central government activities comprise e.g. operating surpluses from the public enterprises, interest income and other central government charges. In fiscal 1982/83 these sources are estimated to yield 18.2 billion kronor.

JAPAN:

Budget 1982–83

See for a detailed discussion of the Japanese tax system the Bureau's publication: Taxes and Investment in Asia and the Pacific.

The Japanese Ministry of Finance announced the following tax measures which the Government wishes to introduce in the financial year 1982-83.

I. Corporate income tax

(1) *Reserve for bad debts*

The reserve for bad debts will be reduced as follows:

Business of the corporation	*Percentage of receivables* Present	1982	1983
Retail or wholesale	1.6	1.4	1.3
Retail on installment payments	2.0	1.8	1.6
Manufacturing	1.2	1.1	1.0
Other kinds of business	1.0	0.9	0.8

(2) *Special depreciation*

The rate of the initial depreciation deduction will be reduced by 2 percentage points. For instance, the initial depreciation deduction for the prevention of environmental pollution will be reduced from 27 to 25%.

(3) *Entertainment expenses*

The deduction of entertainment expenses will be restricted. Under current law, corporations may deduct entertainment expenses in the following manner:

Corporations	*Deductible amounts*
– Corporations with capital of ¥ 10,000,000 or less	¥ 4,000,000 + 90% of the excess
– Corporations with capital over ¥ 10,000,000 but not exceeding ¥ 50,000,000	¥ 3,000,000 + 90% of the excess
– Corporations with capital over ¥ 50,000,000	¥ 2,000,000

Under the new provisions deduction will be limited to the fixed amounts and no deduction at all will be permitted for excess amounts. Corporations with capital in excess of ¥ 50,000,000 will no longer be allowed to deduct entertainment expenses.

(4) *Special tax treatment of capital gains derived from the transfer of real property*

A special additional capital gains tax is imposed on the sale or transfer of land, etc. acquired after 31 December 1969. The rate of this tax is 20%. This tax will henceforth apply to transfers of real property within 10 years after acquisition.

II. Individual income tax

Capital gains derived from real property acquired before 1 January 1969 (long term capital gains) are subject to a special income tax which is imposed at varying rates. This tax will henceforth apply to property transferred within 10 years from acquisition.

ZAMBIA:

Budget 1982

Extracts from the Budget Speech pronounced on 29 January 1982
by Mr. Kebby S.K. Musokotwane, Minister of Finance

See for a detailed discussion of the Sri Lanka tax system the Bureau's publication: Taxes and Investment in Asia and the Pacific

FISCAL MEASURES

91. Mr. Speaker, Sir, it is evident from my earlier remarks that the economic and financial situation continued to deteriorate in the year just ended. I have also tried to convey the message that prospects for any meaningful improvement in this situation remain, at best, modest in the course of this year. In the light of this grim scenario and bleak outlook, the immediate and vital lesson for the Nation is, I believe, clear. The Nation must brace itself for more sacrifices and hard work.

92. Indeed, it is opportune for me to remind the House and the entire Nation that resources allocated to various national needs by the Government come from the people themselves through the payment of taxes and other levies. The responsibility of the Government is to collect such resources for equitable redistribution to important areas and for the purpose of achieving equitable distribution of incomes in the form of transfer payments.

93. Sir, I have in my address emphasised continued need to restructure the economy. The major component of this structural adjustment policy is the reallocation of our scarce resources away from consumption towards productive uses. This is one of the cardinal themes of this year's Budget. Consequently, the majority of budgetary and economic policy prescriptions included in this address are geared towards the attainment of this goal. Of critical significance are the following:

- the need for further reductions of subsidies;
- the need to move determinedly and progressively in the implementation of economic pricing;
- the need to enhance the operational effectiveness and financial viability of parastatal enterprises; and
- the necessity of restraining the growth and, preferably, achieving reductions of non-essential recurrent expenditures.

94. I have also made it clear that financial discipline and control are absolutely essential for all sectors particularly in the Government and parastatal sectors. With this in mind, Government expenditure has been set at levels which I believe to be realistic and necessary for the efficient operation of Ministeries and Departments. Therefore, Controlling Officers and others responsible for financial control and management should not view their responsibilities simply within the narrow limits of their respective agencies but within the broader national perspective.

95. Mr. Speaker, Sir, in arriving at the total expenditure, I have been guided by the level of recurrent revenue likely to be available this year. Of the total revenue of K1,038.3 million, I anticipate raising K135.7 million through new revenue measures which I shall announce shortly. In the case of Zambia, excessive reliance on taxes on international trade entails considerable risk, particularly during periods of depressed copper prices and economic conditions in general. This fact has been vividly demonstrated by the continued lack of mineral tax revenue as well as the unpredictable and fluctuating levels of revenue from import duties. As a consequence, I am compelled to rely on excise duties. The new measures will, admittedly, have the unpleasant but necessary effect of raising, for the Government, the required additional revenue. I have been compelled to resort to these measures in view of the inexorable increase in public expenditure. Therefore, society has, regrettably, to bear the burden of financing this increase in expenditure. It is my conviction that the ever-increasing demands made on the Government have to be matched by the readiness to make additional contribution through taxation.

96. Accordingly, I have had to broaden the scope of indirect taxation to raise the required revenue. The bulk of the additional revenue will therefore come from excise duties.

(a) Excise duty

97. Mr. Speaker, Sir, I propose to raise duty on the following items:

(i) Clear beer: by 5 ngwee per 375 millilitre bottle;
(ii) Opaque beer: by 1.2 ngwee per litre;
(iii) Cigarettes: by 10 ngwee on the most expensive brands of 20 cigarettes;
- 5 ngwee on the middle brands of 20 cigarettes;
- 3 ngwee on the cheapest brands of cigaresttes;

(iv) Pipe tobacco: from K3.00 to K4.00 per kilogram;
(v) Potable spirits: from K7.00 to K8.00 per proof litre;
(vi) Mineral water: by 4 ngwee per bottle; No increases are proposed in respect of other non-alcoholic beverages such as orange squash, raspberry and strawberry juices which are predominantly consumed by our rural communities.
(vii) Sugar: by 4 ngwee per kilogram.

Sir, I expect to raise K12.5 million from clear beer, K2.0 million from opaque beer, K5.0 million from cigarettes, K4,000 from pipe tobacco, K250,000 from potable spirits, K6.7 milion from mineral waters and K2.4 million from sugar, as additional revenue.

Petroleum products

98. Mr. Speaker, Sir, Honourable Members are aware of the increasing portion of foreign exchange earnings consumed by imports of petroleum, oils and motor spirits. In 1980, the oil bill reached K130.0 million and rose sharply to over K205.0 million last year. This upward trend is expected to continue this year. In view of the soaring oil prices which are entirely beyond Zambia's control it is therefore imperative that the Nation should evolve a comprehensive energy policy. Such a policy shuld reflect the essential elements of fuel conservation, the development of alternative energy sources and measures to move towards a balance between demand and supply for energy. The current imbalance should be progressively restored by adequate price adjustments.

99. Mr. Speaker, Sir, pending the formulation and implementation of a comprehensive energy policy, I wish to urge the entire Nation to exercise the utmost economy in the use of this resource. In this respect the Government will continue to encourage and reward efficient energy use through the provision of appropriate incentives particularly for industry. The business community may wish to know that the Government, under the relevant customs and excise provision, may grant rebates in respect of imported equipment and machinery for the purpose of conversion to alternative and cheaper sources of energy, such as electricity.

100. Mr. Speaker, Sir, in view of the foregoing I propose to increase duty on premium and regular petrol by a flat rate of 3 ngwee per litre; an increase of 5 ngwee per kg on liquefied gas; and an increase of 9 ngwee per litre on diesel. The proposed increase on diesel should not have adverse implications for our farming community in respect of which significant incentives, including producer prices, have been awarded. As is well known, the cost of diesel is fully reflected in the determination of crop producer prices. Sir, on kerosene, I propose to introduce a modest increase in duty of 5 ngwee per litre. Honourable Members are aware that this product has for a long time enjoyed a zero-rate of duty. These measures are expected to yield K32.6 million.

101. These measures take effect from midnight tonight. However, I must caution and remind the business community that their current stocks for which they have paid the existing rates of duty are not affected by these measures. Consequently, the prices must remain unchanged. Adjustments may only be effected on sale of goods supplied by manufacturers after midnight tonight.

(b) Customs duty

(i) Bicycles

102. Mr. Speaker, Sir, I propose to remove the suspension of duty on all bicycles imported into the country. Sir, this measure is intended to afford protection to our budding

Chipata Bicycle Plant which is expected to become operational this year. I consider this increase to be modest and should not therefore lead to disruption in the supply of imported bicycles as our plant establishes itself. The protection is merely designed to ease the plant's teething problemes in its infancy.

(ii) Boats, ships and launches

103. Under the provisions of the same subsidiary legislation, I have introduced a suspension of duty on all imported boats, ships and launches designed for use in fisheries and inland waterways, including vessels used in scientific research. I hope Mr. Speaker, Sir, that this will alleviate the hardship experienced by persons and organisations engaged in the activities I have just mentioned.

(iii) Customs tariff

104. Mr. Speaker, Sir, I propose to make adjustments to the existing customs tariff affecting various imported items. These adjustments have been necessitated by the need to take into account the rising prices of imports. These changed circumstances have made it appropriate to charge duty by value rather than by weight or quantity. I expect to raise K15.0 million from this change in the method of levying duty.

(c) Sales tax

105. Mr. Speaker, Sir, under the Sales Tax Act, I have not proposed any major revenue measures except that I have made structural changes in the tariff applicable to electricity, school uniforms and toothpaste. The significant aspect of these changes in respect of the last two items is that sales tax has been removed on school uniforms and the rate on toothpaste has been reduced from 50% to only 20%.

(d) Import licence levy

106. I propose to increase the levy on import licences from 2 to 5%. This increase is in conformity with the continued need for the rationalisation of the country's foreign exchange use and also to discourage frivolous applications for foreign exchange. This measure should discourage such behaviour without unduly deterring genuine and serious importers. I expect to raise K13.5 million from this measure which becomes effective from midnight tonight.

(e) Air passenger tax

107. Mr. Speaker, Sir, I propose to raise this tax from K8.00 to K10.00 on international flights and from K2.00 to K4.00 on domestic flights as from midnight tonight.

108. I expect to raise an additional K430,000 from this measure. In this measure I am fully cognisant of the need to promote tourism as well as domestic air transport. Notwithstanding both these objectives, it is clear that in the prevailing economic conditions these categories of passenger traffic should make additional contribution towards the maintenance costs of airport services and facilities. Furthermore, the Nation will readily acknowledge that Zambians have remained free to make frequent trips abroad despite the fact that such trips entail costly use of the nation's scarce foreign exchange resources. The Government does not intend to restrict this privilege. However, it is strongly felt that a modest increase should be imposed on those of our nationals who continue to enjoy this privilege.

109. In this connection it is worth noting that the Government intends to limit the number of trips abroad undertaken by public officials including civil servants and executives in the parastatal sector. This should create substantial savings for the Government and the Nation as a whole since it affects balance of payments through outflows of foreign exchange.

(f) Foreign currency purchase (education and travel) levy

Mr. Speaker, Sir, in my address, I made repeated reference to the foreign exchange constraint. In this connection, it has become imperative to rationalise our use of this scarce resource. Accordingly, I propose to impose a levy of 10% on the kwacha equivalent of foreign currencies applied for and purchased from any commercial bank within the Republic in respect or travel and education outside Zambia. For this purpose, I am proposing to exempt from the purview of this measure, travel undertaken on Party and Government business, approved medical grounds as well as Government sponsored scholarships. I expect to raise K2.5 million from this source.

(g) Commodity loans

111. Mr. Speaker, Sir, I propose that commodities procured by Government under certain commodity arrangements with donor countries should be sold on the open market. I believe that this measure is necessary in order to rationalise the procurement and utilisation of such commodities and equipment similarly obtained. It would further encourage a co-ordinated and disciplined approach to the procurement and utilisation of external assistance on the part of Government agencies. It is therefore essential that the Government should resort to the arrangement I have proposed in order to finance the local cost component of externally funded projects. I expect this measure to yield K58.1 million. This proposal is with immediate effect.

(h) Income tax

112. Mr. Speaker, Sir, I now wish to propose a number of measures affecting direct taxes. Sir, before I do so, I would like to state that a number of representations have been made by our citizens, individually and severally, regarding the high incidence of our tax. I have received and considered such representations with sympathy. In line with the democratic nature of the Party and its Government, I have, in the recent past, made a few concessions which have lessened, to a certain degree, the incidence of direct taxes. At the same time, I should stress that the major constraint to significant reductions in the effective tax burden continues to be the inadequate levels of revenues available to the Government relative to the increasing levels of expenditure. I should point out that it is extremely difficult to effect meaningful reductions in Government expenditures, especially recurrent, without impairing the operational effectiveness of Government agencies. In spite of the foregoing, I wish to propose the following tax measures:

(i) Personal allowances

113. Mr. Speaker, Sir, I propose to raise:
- Married allowance from K1,500 to K1,700;
- Single allowance from K600 to K650;
- Child allowance from K225 to K275;

Sir, it is my considered opinion that the increased allowances I have just proposed, modest as they may appear, will effectively reduce the tax burden on the Zambian people, I estimate that these measures will result in a loss of K8.0 million to Government.

(ii) Married women

114. Mr. Speaker, Sir, several representations have been made to me by our working married women to reduce the tax burden currently borne by them. Indeed, the UNIP National Council, at its 16th Session, considered and adopted a resolution in this matter.

115. Sir, under the present system, the taxable incomes accruing to a wife and husband are taxed separately at parallel rates. The underlying cardinal characteristic of the present system is the recognition of the family as a single taxable unit. The effective tax burden on the family is lower under this system as opposed to the system which prevailed prior to 1st April, 1970. Until then, the income accruing to the wife was added to that of her husband for the purpose of determining the tax payable. Consequently, the husband's income was subject to tax at a higher rate. As an illustration, under the present system, both the husband and wife, after taking into account personal allowances to the husband, are taxed separately but at the same rate of 5% each on their respective first taxable K1,000. In short, they pay an amount of tax of K50 each. This is in contrast to the old system whereby this same family would have paid K150 in taxes.

116. Sir, in view of the foregoing, and given the desirability of continuing to consider the family as one taxable unit, I am proposing that the working wife and husband should be allowed to elect for separate assessment so that the married allowance can be apportioned between them.

117. Mr. Speaker, Sir, for this purpose, the husband and wife will be required to make an irrevocable election six months prior to the commencement of the effective charge year regarding the apportionment of married allowance.

118. I believe, Sir, that this is a reasonable and equitable way of implementing the directive of the Party on this issue. In this way, the demands of those wives who insist that their husbands are not fulfilling their role as head of the household, will be met.

(iii) Savings

119. Mr. Speaker, Sir, it is now a matter of public interest and concern that the rate of savings remains unsatisfactory. It is therefore

the wish of the Party and its Government to encourage savings. I need not over-emphasise the importance of savings for investment, employment generation and accelerated development in general.

120. In order to provide an inducement to greater savings, I propose to increase the tax relief on interest earned by individuals on savings accounts from K200.00 to K400.00 held in commercial banks. In particular recognition of the need for the Zambia National Building Society to attract more resources for lending, I propose to increase tax relief on interest earned on savings accounts from K200 to K500. In the case of the Zambia National Credit and Savings Bank, I propose to raise the tax relief to K600. I trust that these measures will motivate Zambians to save more.

(iv) Pension contributions and annuities

121. Mr. Speaker, Sir, under section 37 of the Income Tax Act, relief in respect of pension contributions is limited to K1,200 or 10% of the contributor's basic emoluments liable to tax for each charge year. I propose that the figure of K1,200 be raised to K2,400. Under the same section, relief on an annuity is limited to K2,400 of the individual's assessible income. I propose that the figure of K2,400 be raised to K3,000.

(v) Co-operatives

122. Mr. Speaker, Sir, the Party and its Government attach great importance to the role of the co-operative movement in the development of this Nation, in particular rural development. It provides an effective and efficient means of increasing production, leading to a better distribution of incomes. This would further result in the reduction of the existing rural/urban income disparity. In line with this objective, I propose to increase the income of a member allowed for tax purposes from K600 to K800 per annum.

(vi) Donations to UNIP

123. Sir, I propose to grant income tax relief in respect of donations to the party from the public and institutions alike. I trust that this measure will attract the necessary funds to facilitate the implementation of vital Party projects and programmes.

124. Mr. Speaker, Sir, the measures I have proposed will take effect from 1st April, 1982.

(vii) Company tax

125. Mr. Speaker, Sir, the Party and its Government are determined to strengthen the role and contribution of our commercial enterprises to the development of this Nation. To that end the Government recently granted a wide range of incentives and concessions. However, the contribution of our enterprises has been constrained by the methodology used in determining and collecting taxes levied on them.

126. Under the present system, tax liability is assessed on the basis of profits earned by companies and self-employed individuals in the year preceding the charge year. This is in contrast to the present method of collecting taxes on current basis applicable to the wages and salaries of employees under the Pay As Your Earn (PAYE) Scheme. In other words, the earners of wages and salaries are taxed on the basis of current income. Sir, this difference in the basis of assessing tax is, to say the least, discriminatory. It discriminates in favour of companies and businesses and against the employees. It affords the concerned tax-payers the opportunity of an interest-free loan at the expense of Government. It further provides those tax-payers with an opportunity to take advantage of depressed economic or inflationary conditions.

127. Lastly, it makes the implementation of public programmes difficult in that the flow of tax revenue is rendered uneven and unpredictable.

128. In view of the foregoing. Mr. Speaker, Sir, I propose that the tax liability on profits of companies and self-employed individuals should be assessed on current income basis. The tax wil be payable on a quarterly basis. This proposal will make income tax reflect the current state of our economy and responsive to the changes in the economy. In order to facilitate and reduce the burden on the affected tax-payers, I further propose the following transitional arrangements:

(a) For the charge year (1981/82) ending 31st March, 1982 the tax will be payable on 14th August and 14th December, 1982.
(b) For the charge year (1982/83) ending 31st March, 1983, profits and other accrued income will be estimated by the affected tax-payers and the tax liability will be assessed at current rates applicable as from 1st April, 1982. The tax so assessed will be payable to the Commissioner of Taxes in the following quarterly instalments:
30th June, 1982
30th September, 1982
30th December, 1982
30th March, 1983
(c) For the charge year (1983/84) and subsequent charge years ending 31st March each year, tax will be due and payable in the four quarterly instalments except that payment must be made not later than the 14th of the following month after the due date.

129. Mr. Speaker, Sir, it will be evident that the proposed current basis of tax assessment introduces, in effect, some degree of self-assessment on the part of the affected tax-payers. On receipt of the actual income tax returns and accounts for 31st March of each year, the Commissioner of Taxes will determine the correct tax liability and give credit, wherever applicable, for the provisional tax paid. Any shortfall will be paid within thirty days, as at present.

130. The degree of self-assessment arising from my proposal will entail the freedom on the part of the affected tax-payers to revise their estimate in respect of any subsequent instalment payment. This, however, will be subject to the condition that any under-estimation of the tax liability (at the end of the accounting period) by a third, will attract a 10% penalty on the amount so under-estimated. Such penalty must be paid within thirty days. The existing 5% penalty imposed monthly on the outstanding tax will remain in force.

131. Notwithstanding the proposed system, the Commissioner of Taxes will still retain the power to issue a demand notice for assessment to any tax-payer in respect of any charge year, as already provided for under the Income Tax Act.

132. Mr. Speaker, Sir, it is evident from what I have just elaborated that the tax burden will be quite heavy during the transitional period. It means that tax due for two years will be paid in one year. However, it should be appreciated that this will occur but once in the 1982/83 charge year.

133. Mr. Speaker, Sir, in recognition of the hardship that might be experienced by some tax-payers during the transitional period, I am proposing a reduction of the company tax rate from 50% to 45% from 1st April, 1981. I am confident that with this reduction business activity will not be adversely affected as we move to the proposed rational system in tax administration.

(viii) General

Undistributed profits

134. Mr. Speaker, Sir, I now wish to discuss the undistributed profits tax (UPT) which has been a subject of numerous representations by affected tax-payers. Indeed a specific resolution was adopted on this issue by one of the Economic Symposia organised recently under the auspices of the Rt Honourable Prime Minister.

135. In recognition of the several representations made to me as the imperative need to stimulate business activity and reactivate our economy, I have decided to introduce a more effective and workable system "of deeming" in place of the undistributed profits tax.

136. Sir, the new provision will essentially remove the indiscrimate penalty for non-distribution and identify only those companies which never plough back their profits into the business. This will be evidenced by, for example, accumulations of cash or investments in non-trading assets. Furthermore, the tax on undistributed profits will be levied on the shareholders to whom the income properly belongs. The details of this provision will be given in the relevant legislation which this House will consider soon.

Tax clearance certificate for small-scale business and self-employed individuals

137. Mr. Speaker, Sir, tax evasion is committed in various forms such as failure to report income to the Tax Department, under-stating income and by the maintenance of poor or no business records. Unwittingly or not, this amounts to concealing their correct income for tax purposes.

138. In order to ensure that they are compelled to observe the law and report their income to the Department of Taxes, I am proposing that they be required mandatorily to obtain tax clearance certificates to show that they have satisfied their tax liability before their trade licences can be issued or renewed. Sir, it is only fair that the tax burden should be borne equitably by all eligible persons. Unless this is achieved, all attempts to make meaningful reductions in the effective tax rate will be futile.

(i) Parastatals–Revenue contribution

139. Mr. Speaker, Sir, last year I raised the matter of parastatal organisations and their

contributions to Government revenue. At the time my proposal was to make them liable to tax as any other commercial enterprise, I regret to report that I am unlikely to raise any significant revenue by this method due to the seemingly poor performance of the majority of the parastatal organisations.

140. Sir, total Government investment in the parastatal sector is in excess of K1.5 billion of which about K750 million is in the form of equity. I propose to impose a levy of 1.5 per cent on this equity in the parastatal sector. This levy will help us to expose inefficient parastatal organisations and identify the underlying contributing factors, such as poor management, structural or other organisational defects.

141. By this measure, I do not intend to penalise the efficient and profitable organisations. Such organisations shall not be required to pay both company tax and the proposed levy. They shall only pay the greater of the two. In essence, the levy shall apply to those parastatal enterprises which continue to be inefficient in spite of the progressive implementation of economic pricing for their products. I expect to raise K11.25 million from this measure.

(j) Fines, licences and fees

142. Mr. Speaker, Sir, in the prevailing conditions, I have noted that some of the fines, licences and other taxes are far too low and have not been revised for a long time now. I propose to effect changes to the relevant pieces of legislation in order to raise additional revenue for Government. This proposal will become effective from 1st April, 1982. I expect to raise K2.0 million from this measure.

(k) Revenue administration

143. Mr. Speaker, Sir, in order that Government does not lose revenue due to it, I intend to strengthen its principal revenue collection agencies that is, the Departments of Income Tax and of Customs and Excise. In this connection, I have deliberately increased the allocation of funds to these Departments to make their operations more effective. In addition, I propose to establish a Revenue Unit in my Ministry which will, among other functions, liaise closely with all revenue collection agencies within the Republic. It is my sincere hope that by strengtening our revenue collection, the Government should be able to tap resources which have so far remained uncollected.

PART VI

INCENTIVES

(a) Agricultural sector

(i) Farming income tax rate

144. Mr. Speaker, Sir, last year I announced additional measures to boost the implementation of the Operation Food Production Programme. The measures included accelerated depreciation of farming machinery, equipment and implements at 50% of the cost of the assets on a straight-line basis. I restricted the maximum tax rate to 25% on farming income, and introduced a development allowance for growers of tea, coffee and citrus fruits. This year, I propose a further reduction of the tax rate to 15% on income arising from agricultural operations.

(ii) Selective employment tax

145. Mr. Speaker, Sir, I propose to remove the payment of Selective Employment Tax on the incomes of expatriate personnel cngaged in the agricultural sector. The measures I have announced should go a long way towards increased agricultural production, food sufficiency and improved nutritional standards throughout the Republic.

(b) Industrial sector

(i) Foreign exchange credit

146. Mr. Speaker, Sir, Hon. Members will have noted that one of the main themes of my address has been on foreign exchange or the lack of it. Indeed in his address to the 16th National Council of the United National Independence Party on the 14th December, 1981, His Excellency the President stated among others and I quote:

> "This lack of alertness to the export opportunity is understandable considering the transportation and other problems that we have had in the past. But this indiffence must end now if we are to survive. From now on it's 'EXPORT or PERISH'."

147. Sir, in response to this timely warning my Ministry has taken time to study the problem and evolve methods to make export trade enterprising and lucrative to those engaged in it. In this connection, I propose to introduce, in consultation with my colleague in the Ministry of Commerce and Industry, measures which will entail the following:

- the establishment of an Export Guarantee Agency to protect the interest of Zambian exporters;
- the introduction of foreign credit system by which any exporter who earns foreign exchange will be given credit of up to 50% of the net foreign exchange earned; and
- preferential tax rate on income earned from exports.

(ii) Wear and tear allowance

148. Sir, as Honourable Members are aware manufacturers of soft drinks have been unable to satisfy the market, particularly to rural areas. In order to facilitate wider distribution of these products, I propose to grant them relief on any new plant and machinery they acquire provided they establish such plant and machinery in rural areas. In this case depreciation will be over a five-year pcriod and based on the sum-of-years-digits method.

(c) Training of Zambians in professional fields

149. Mr. Speaker, Sir, last year, I increased the rate of selective employment tax to 20% and disallowed the tax as a deduction for tax purposes. I have since given sympathetic consideration to the effect of this tax and have decided to grant some relief for expenses incurred in the training of Zambian employees towards professional qualifications in such specialised and professional fields as accountancy, architecture.

In next issues:

The welfare cost of taxation: its meaning and measurement
– by *Nizar Jetha*

The Peruvian tax reform
– by *Pedro Massone*

Singapore's 1982 Budget
– by *Lee Fook Hong*

Tax relief for Americans abroad – an overview
– by *Piroska E. Soos*

The 1982 income tax changes in the Republic of South Africa
– by *Erwin Spiro*

Highlights of the tax proposals of the Indian Budget for 1982-83
– by *Dharmendra Bhandari*

Taxation of foreign business activities in Austria
– by *Wolfgang Gassner* and *Geoffrey Pink*

MALTA:
Budget 1982

Extracts from the Budget Speech pronounced on 2 August 1981 by Dr. J. Cassar, Minister of Finance, Customs and People's Financial Investments.

REVENUE 1982

Revenue during 1982 is estimated to amount to a total of £M218.8 million. This is made up of ordinary revenue of £M203.2 million, grants amounting to £M8.6 million and foreign loans of £M7 million.

Revenue from customs is estimated to amount to £M44.1 million, that is, about 3 million more than in 1981.

Although we shall raise the rate of customs duties on 2 items as I shall explain later on, the increase in the total revenue from customs is mainly due to higher prices for imported merchandise which, as the House is aware, is taxed ad valorem, that is according to value.

We are proposing to increase slightly customs duty on imported wines and lead crystal. As regards the increase in customs duties on imported wines, of 9 cents on a bottle of wine, 10 cents on a bottle of vermouth, and 12 cents on a bottle of champagne, this increase is intended to protect further local wines, whilst the increase in the rate of duty on lead crystal, which will now be as high as that on ornamental glass, as it was some time ago, is intended to eliminate the difficulty which often arises in distinguishing one from the other. These measures are estimated to increase Revenue by about £M100,000 a year.

Entertainment tax exemptions

In order to further encourage sports and cultural activities in our country, Government intends to exempt cultural live shows by local talent and football from entertainment tax.

The reduction in revenue from this source is expected to be about £M130,000.

INCOME TAX

Now I come to the measures which the Socialist Government will propose on income tax. But before I go into detail I would like to say something about this tax and the many rumours circulating about it.

Income tax was introduced in Malta by the Labour Party when this came to power for the first time in 1947. From the very beginning opponents of the Labour Party came all out against it, there were some who even tried to get religion into it. Time proved us right because many came to believe that as the main direct tax, income tax is the most just tax on earth and this results in the fairest and most just distribution of wealth.

But, over the years, people who should know better continued to make political capital out of income tax. During the 1960s there was one party that advocated an end to income tax. The Nationalist Party, which was then in power, was against this, ridiculed the idea and declared it as impossible. But later, one the eve of the 1971 elections, the Nationalist Party also promised that if re-elected it would abolish income tax. The people voted otherwise. The same thing happened in 1976 although once again the Nationalist Party reiterated the promise of abolishing income tax.

Today the Opposition Party has suddenly abandoned the promise of an end to income tax. But at the same time they seize every opportunity to incite the people against this tax. Such tactics should come to an end. All honest people should know and understand that Government expenditure, which is to the benefit of the whole population, must come from somewhere and when it comes to taxes, income tax is the most just tax of all.

Against this background I will now come to the measures which we are proposing.

First of all, in order that income tax will not erode the greater part of the wage increase I announced earlier, we are proposing that as from basis year 1982 personal allowances will rise by £M130 for a married couple and £M75 for a single person. This means that the personal allowance for a married couple will rise from £M1070 to £M1200 and for a single person from £M635 to£M710.

This means also that since the Maltese Socialist Party came to power, personal allowances have risen by £M660 for a married couple and by £M410 for a single person, that is these allowances more than doubled under the Socialist Administration. It is worth mentioning here that in the period 1962–1971 these personal allowances rose by only £M120 and £M60 respectively, a rise of approximately only 25%.

Moreover, we are proposing another measure in connection with income tax. In fact the tax rates and the bands regulating this tax which will come into effect as from basis year 1982 will be adjusted as shown in Table No. VI which I will read.

These measures are really very important because of their effect on the taxpayer whether employed or self-employed.

TABLE VI
Changes in income tax rates

Present rates		
Personal deductions:	Single	£M 635
	Married	£M 1,070
Rates:		
On the first taxable	£M 100	5c in the £M
On the next	£M 100	10c in the £M
On the next	£M 500	15c in the £M
On the next	£M 500	20c in the £M
On the next	£M 600	25c in the £M
On the next	£M 1,200	30c in the £M
On the next	£M 600	40c in the £M
On the next	£M 600	50c in the £M
On the next	£M 800	60c in the £M
On the rest		65c in the £M
New rates		
Personal deductions:	Single	£M 710
	Married	£M 1,200
Rates:		
On the first taxable	£M 200	2c in the £M
On the next	£M 100	5c in the £M
On the next	£M 100	7c in the £M
On the next	£M 200	10c in the £M
On the next	£M 300	15c in the £M
On the next	£M 500	20c in the £M
On the next	£M 700	25c in the £M
On the next	£M 1,500	30c in the £M
On the next	£M 700	40c in the £M
On the next	£M 700	50c in the £M
On the next	£M 2,000	60c in the £M
On the rest		65c in the £M

To bring out this point more clearly Tables VII and VII detail the effect of these income tax measures as well as the reduction in tax in the various income brackets.

While once again I call upon the House to take these tables as read, I feel it is appropriate at this stage to give some general examples.

As a result of the changes we are proposing, a person who this year pays £M15 in tax, in 1982 will pay only £M4 – a saving of 73% in tax. A person now paying £M30 per annum will pay £M9 in 1982 – thus saving 70%. Those now paying between £M75 and £M130 in tax will next year pay between £M34 and £M79 – thus saving between 55% and 38% and this always in spite of the fact that their income will rise through pay increases and higher social benefits.

The above examples cover the great majority of Maltese workers, including those in factories, at the Drydocks and in the Civil Services.

As a result of these measures and the increases in pay, bonus and children's allowance, a married worker with 3 children earning the minimum wage next year will have about £M224 more left in his pocket after paying his income tax and insurance contributions. If the same worker, married with 3 children, is in Government employment in Group C or a clerk he will have £M230 in his pocket.

A Drydock's worker is also at this level. Even those who are single or married without children will also be having next year about £M90 more in their pockets than they have this year. This means that every worker supporting a family of 5 persons, no matter who he is and where he works, will not only have all the increase of £M3 a week left, together with the increase in bonus, but because of the new income tax measures he will have left at least another pound per week.

Although everybody is going to pay less tax, those earning the minimum will still be paying a small amount. The Socialist Government believes that everyone is in duty bound to help carry a bit of the social burden; everyone must think of others and contribute for the good of others according to his means, if we really want to have a Christian and humane society, a socialist society.

Those who are in the high income bracket, including the self-employed, will also be benefiting from the measures we are proposing because they too will be having more money left at their disposal.

This is being done because it is right that the relativity between those who earn most and those who earn less must not continue to be closed up: this is being done so that the incentive to work will also remain for those in the higher income bracket.

On the basis of 1982, at the present rates, the Government was expecting to collect £M22 million in tax from the employees and the self-employed.

With the £M3 a week increase in wages and the £M16 increase in bonus together with the increase in children's allowance, Government next year would have collected, at present rates, £M26 million. Taking the new rates and the increase in the ceiling which we are proposing for next year, it is calculated that from the employees and the self-employed we will be collecting about £M18 million.

This means that through these measures on income tax, tax collection on the basis of assessment for the basic year 1982 will be about £M8 million less than what the income would have been had not these measures been taken.

The government could do this because it enlarged and strengthened the public sector which is now yielding enough tax so that Government is in a strong position to make this concession.

The Socialist Government, in the name of honest and serious people, hopes that in this way motivation for work will increase as will reliability in paying income tax.

At the same time it must be appreciated that, as I have already explained, these increases will cost the Government a great deal of money and it is therefore essential that everyone cooperates, particularly the self-employed who do not pay through the PAYE system as employees do. Every effort must be made so that tax due is collected efficiently during the same year the income or profit is earned. For this goal to be attained, as has been done in the case of employees with the introduction of the PAYE system, another reform must be put through whereby payment of provisional tax is effected more frequently so that during the year of assessment (the year following the one during which income or profit is earned) it will only be necessary to make some minor adjustments as in the case of PAYE.

It is hoped that the self-employed will reciprocate the good will Government is showing by effecting these decreases in taxation. At

TABLE VII
How the net income* of several categories of employees is going to increase

Status, income & increase	*National minimum wage*	*Group C employed by Government*	*Group D Clerk II, etc. employed by Government*	*Clerk III, Teacher I etc. employed by Government*
	£M	£M	£M	£M
Married, 3 children				
Net income 1982	1954	2213	2287	2511
Net income 1981	1730	1983	2057	2275
1980 Increase £M	224	230	230	236
Percentage increase	12.9%	11.6%	11.2%	10.4%
Married, 2 children				
Net income 1982	1862	2119	2193	2416
Net income 1981	1640	1892	1968	2183
1982 Increase £M	222	227	225	233
Percentage increase	13.5%	12.0%	11.4%	10.7%
Married, 1 child				
Net income 1982	1722	1979	2053	2276
Net income 1981	1511	1765	1839	2053
1982 Increase £M	211	214	214	223
Percentage increase	14.0%	12.1%	11.6%	10.9%
Married without children				
Net income 1982	1540	1797	1871	2094
Net income 1981	1350	1604	1678	1892
1982 Increase £M	190	193	193	202
Percentage increase	14.1%	12.0%	11.5%	10.7%
Single				
Net income 1982	1481	1712	1782	1992
Net income 1981	1282	1521	1591	1795
1982 Increase £M	199	191	191	197
Percentage increase	15.5%	12.6%	12.0%	11.0%

* The net income includes the annual bonus and children's allowance where applicable and does not include the National Insurance Contribution and income tax. Where salaries are scaled, the salary has been calculated as having reaching half the scale.

TABLE VIII
How much you will be saving with the new income tax rate

Taxable amount	*How much you used to pay before*	*How much you will be paying in 1982*	*How much you will be saving*	*How much you are going to pay less than before expressed as %*
£M	£M	£M	£M	£M
200	15	4	11	73.3
300	30	9	21	70.0
400	45	16	29	64.4
600	75	36	39	52.0
900	130	81	49	37.7
1,400	240	181	59	24.6
2,100	430	356	74	17.2
3,600	940	806	134	14.3
4,300	1,300	1,086	214	16.5
5,000	1,720	1,436	284	16.5
7,000	3,020	2,636	384	12.7

the same time, the Government will be taking administrative measures through the Department of Inland Revenue so that every employee paying PAYE will benefit immediately during 1982 itself from the reductions being proposed in income tax. In fact action towards this end has already been taken when, after this year's Budget, employers were requested to reduce PAYE rates in accordance with the new rates approved last November.

Mr. Speaker,
At the beginning of my speech I briefly showed how the Maltese Socialist Government succeeded, during the past decade, in building a strong economy and increasing the national wealth and how, during this time, it has distributed this wealth on the principles of social justice by helping those who were mostly in need. I also explained that the aim of this Budget is that we follow the principles as propagated in the 5-year Development Plan – 1981/85 in order to consolidate all that we have achieved in the economic and social fields.

Since this Budget is being presented a few months before the general elections, some had predicted that we would use this Budget to create some false sense of well-being. In fact, these same people have also said that when last November we budgeted for a surplus of £M22 million we purposely did this, so that we would have enough money to distribute during election time.

However, it seems that these people have forgotten, or would have wished others to forget, that the Socialist Government has never waited for election time to distribute national wealth to those who deserve it. This Budget is just one of the 11 Budgets which this Government has presented during these past 10 years. It is similar to all the previous Budgets, the purpose of which was to establish a sound economy and increase the national wealth. All these Budgets have contributed towards the progress attained in the social field, to such an extent that even foreigners are mystified how, despite our limitations, we were able to achieve such a high level of progress. This progress is evident in today's standard of living of the workers, in the beautiful and comfortable houses they are occupying in the high protein food which the workers' families are consuming, in the large number of television sets that have been purchased and are still being purchased, in the ever increasing number of telephones installed in workers' houses, in the number of vehicles on the road and how the shops are always thronged with customers. All this apart from the fact that the workers today, as never before, are well insured against any mishap that may occur to them or their families and this thanks to the excellent free social services which the Socialist Government is providing. This is real and true progress which no one can deny, whichever argument one puts forward, be it the water situation or income tax assessments.

The Maltese people are enjoying this wealth because during the past 10 years they had a courageous and hard working government which has always frowned upon indolence. This wealth did not come from nothing.

Consequently this Budget, by improving the benefits to all classes of the population, especially the workers, is following this Government's previous Budgets, it is following the right way, in a responsible and serious manner, that has always led us to victory.

Most of the changes proposed were enacted in Act No. XL of 1981.

Individual persons who have been granted a residence permit under the Immigration Act, 1970 or on or after 14 November 1972 are subject to income tax at favourable rates. These persons are often indicated as "new residents" and they may generally not engage in business, profession or employment or take part in politics.

The rates are:

For every pound of the first £200	2c
For every pound of the next £100	5c
For every pound of the next £100	7c
For every pound of the next £200	10c
For every pound of the next £300	15c
For every pound of the next £500	20c
For every pound of the next £700	25c
For every pound of the remainder	30c

Provided that the minimum liability of any such individual in respect of any year of assessment shall be one thousand pounds.

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This brochure – published by the Commission for Foreign Investment with the Ministry of Trade and Industry (Aleksanterinkatu 10, III, SF-00170, Helsinki 17, Finland –) describes all facts, procedures, etc. that are necessary for the establishment of a foreign enterprise in Finland. It presents basic economic data and also deals with taxation, company law, legislation concerning foreign exchange transactions, financing, tax and other incentives, labor market, etc. An extensive list of all relevant addresses is also included.
(B. 103.507)

France

SCHLEBUSCH, Giselher.
Die neue französischer Mehrwertssteuer TVA im deutsch-französichen Waren- und Dienstleistungsverkehr 1981.
Broschüre Nr. 5.
Paris, Deutsch–Französische Industrie- und Handelskammer, 1981. 98 pp.
Explanation of the French tax on value added with special emphasis on the German–French exchanges of goods and services. The French VAT statute in German translation is appended.
(B. 103.550)

LE GALL, Jean-Pierre.
La fiscalité internationale des Euro-crédits. Théorie et pratique.
Extrait de l'ouvrage "Les Euro-Crédits".
Paris, Faculté de Droit, 1981. 74 pp.
Reprint from "Les Euro-Crédits".
The author discusses the international tax aspects arising from European credits provided by a group of banks.
(B. 103.498)

German (Fed. Rep.)

DANZER, Jürgen.
Die Steuerumgehung.
Steuerwissenschaft band 9.
Cologne, Dr. Peter Deubner Verlag, 1981. 200 pp., 82 DM.
Commentary on the legal basis of the concept of tax avoidance under German law and a discussion of a number of cases in practice which are considered to fall hereunder.
(B. 103.470)

HALLER, Heinz
Die Steuern.
Grundlinien eines rationalen Systems öffentlicher Abgaben. 3. überarbeitete Auflage.
Tübingen, J.C.B. Mohr, 1981. 456 pp., 98 DM.
Third edition of a theoretical study on the fundamental principles of the levying of taxes and the application thereof, the various forms of taxes and the purposes and effects thereof as well as the conditions for a rational tax system

from a double point of view: socio-political and socio-economic.
(B. 103.494)

SCHWARZ, Manfred
Les taxes et impôts allemands.
Cologne, German–Belgo/Luxembourg Chambre of Commerce, 1981. 62 pp.
French–language survey of taxes and fees levied in the German Federal Republic, with emphasis on those which are of interest to a Belgian or Luxembourg investor in Germany.
(B. 103.480)

PILTZ, Detlev Jürgen.
Der Geschäftswert im Ertragsteuerrecht.
Institut "Finanzen und Steuern", Heft 120.
Bonn, Stollfuss Verlag, 1981. 97 pp., 23.50 DM.
Monograph discussing the income tax aspects of good will, including the determination of its value and the special problems in this field relating to the realization of profits and the termination of a business. Based on this discussion the author concludes with a number of propositions which may have an impact on future legislation.
(B. 103.509)

JOHN, Gerd; THEISEN, Manuel R.
Verlustverrechnung in Personengesellschaften.
Schriften de Betriebsberaters, Band 63.
Heidelberg, Verlagsgesellschaft Recht und Wirtschaft, 1981. 187 pp., 48 DM.
Monograph dealing with the provisions regarding loss compensation available to partnerships with emphasis on the restricted possibilities for loss compensation under the new Sec. 15 A of the Individual Income Tax Law, the "negative account".
(B. 103.565)

RICHTER, Heinz
ABC – 100 Steuertips aus Steuer-Telex zur Einkommensteuer.
Cologne, Dr. Peter Deubner Verlag, 1981. 48 pp., 24.80 DM.
Reprint from *Steuer-Telex* dealing with hints relating to the German Individual Income Tax.
(B. 103.469)

SCHLEBUSCH, Giselher
Die neue französischer Mehrwertsteuer TVA im deutsch-französischen Waren- und Dienstleistungsverkehr 1981.
Broschüre Nr. 5.
Paris, Deutsch-Französische Industrie- und Handelskammer, 1981. 98 pp.
Explanation of the French tax on value added with special emphasis on the German–French exchanges of goods and services. The French VAT statute in German translation is appended.
(B. 103.550)

KAPP, Reinhard
Schwerpunkte des Erbschaft- und Schenkungsteuerrechts.
Schriften des Betriebsberaters, Band 61.
Heidelberg, Verlagsgesellschaft Recht und Wirtschaft, 1981. 159 pp., 39 DM.
Monograph discussing the most important principles of the German inheritance and gift tax law.
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HANGARTER, Dieter
Das deutsch-schweizerische Doppelbesteuerungsabkommen.
2. neubearbeitete Auflage.
Zürich, Handelskammer Deutschland–Schweiz, 1980. 30 pp., 25 Sfr.
Brochure explaining the most important details of the German–Swiss double taxation treaty.
(B. 103.461)

HARTMANN, Rainer
Investitionszulagengesetz (InvZulG).
Kohlhammer Kommentare.
Stuttgart, Verlag Kohlhammer, 1981. 188 pp., 29.80 DM.
Discussion of the various provisions of the German Law on Investment Allowances. The book also contains the text of the Law and a number of appendices containing regulations implementing the Law.
(B. 103.520)

Ireland

AN SEACHTÚ TUARASCÁIL
bhliantúil is caoga ó na coimisinéiri ioncaim.
Fifty-seventh annual report of the revenue commissioners.
Dublin, The Stationery Office, 1979. 177 pp., £ 1.95.
(B. 103.626)

SAUNDERS, Glyn;
HARVEY, Eric L.
Tolley's taxation in the Republic of Ireland 1981-82.
Croyden, Tolley Publishing Comp. Ltd., 1981. 193 pp., £ 7.50.
A detailed guide covering income tax, corporation tax, capital gains tax, capital acquisitions tax, value-added tax, resource tax, and wealth tax and including the provisions of the Finance Act 1981.
(B. 103.646)

Netherlands

WITTEVEEN, D.E.
De nieuwe vermogensbelasting.
Arnhem, Gouda Quint, 1981. 166 pp., 39.50 Dfl.
Guide explaining the present net wealth tax with reference to case law.
(B. 103.562)

OPVOLGINGSPROBLEMEN BIJ
familiebedrijven.
Amsterdam, Klijnveld Kraayenhof & Co., 1980. 31 pp.
Booklet explaining the problems arising from succession in family-owned enterprises. Taxation aspects are dealt with.
(B. 103.486)

SCHUTTEVAER, H.;
HERMANS, F.M.J.
Kort begrip van rechtsverkeersbelastingen en registratie. Derde druk.
Arnhem, Gouda Quint, 1981. 208 pp., 32.50 Dfl.
Third revised edition of textbook, thematically arranged, explaining the real property transfer tax and the capital transfer tax and registration matters. Relevant texts of statutes are appended.
(B. 103.537)

VAN DEN TILLAART, H.J.M.;
VAN DER HOEVEN, H.C.; VAN UXEM, F.W.;
VAN WESTERLAAK, J.M.
Zelfstandig ondernemen.
Nijmegen, Instituut voor toegepaste sociologie, 1981. 482 pp.
"Independent enterprise" analyzes the problems and oppportunities of independent enterprises in middle and small scale business.
(B. 103.570)

Spain

MITNAHME VON KRAFTFAHRZEUGEN
und Sportbooten bei Reisen und Übersiedlung nach Spanien.
5. neubearbeitete Auflage.
Madrid, Deutsche Handelskammer für Spanien, 1981. 23 pp., 25 DM.
Fifth revised edition on legal and taxation matters arising from bringing motor cars and sportboats to Spain in connection with travel to or taking up residence in Spain.
(B. 103.534)

LINDE PANIAGUA, Enrique;
LOPEZ REQUENA, Miguel;
GARCIA COTARELO, Ramón;
RUIZ CASTILLO, Francisco;
GONZALEZ RIVAS, Juan José.
Materiales para el estudio y aplicación de la Constitucion española de 1978.
Madrid, Secretaria General Técnica del Ministerio de Justicia, 1980. 883 pp.
The book deals with the Spanish Constitution, jurisprudence of the Constitutional Court during 1979 and 1980 and decisions of the Constitutional Court of Justice and General Directorate of Registrars and Notaries in relation to Constitutional principles during 1980.
(B. 103.546)

Switzerland

HANGARTER, Dieter
Das deutsch-schweizerische Doppelbesteuerungsabkommen.
2. neubearbeitete Auflage.
Zürich, Handelskammer Deutschland-Schweiz, 1980. 30 pp., 25 Sfr.
Brochure explaining the most important details of the German-Swiss double taxation treaty.
(B. 103.461)

ÖFFENTLICHE FINANZEN DER
Schweiz.
Bearbeitet von der Eidgenössischen Finanzverwaltung. Statistische Quellenwerke der Schweiz/Heft 675.
Bern, Bundesamt für Statistik, 1981. 154 pp.
Statistical data for 1979 on revenue and expenditures of the Confederation, the cantons and the municipalities.
(B. 103.459)

United Kingdom

TAXATION AND SOCIAL
policy.
Edited by Cedric Sandford, Chris Pond and Robert Walker.
London, Heinemann Educational Books, 1980. 242 pp., £ 6.50.
Revised papers of various authors prepared originally for the Sunningdale Seminar 1979. The topics cover interactions between direct taxation and social policy (social security, housing, pensions, etc.). Papers include: Taxes, Benefits and the Redistribution of Incomes, by

Geoffrey Stephenson; Taxation and Social Security, by David Piachaud; Taxations and Pensions, by Mike Reddin.
(B. 103.543)

APSION, Gordon
UK corporate tax shelters.
EIU Special report No. 109.
London, The Economist Intelligence Unit, 1981. 89 pp.
Report describing tax-saving possibilities offered by five major tax shelters in the United Kingdom (charitable trust, agricultural land, woodlands, commodities and trading stock).
(B. 103.553)

GRAHAM, T.L.A.
Key to corporation tax.
Finance Act 1981 Edition.
Taxation Master Key Series.
London, Taxation Publishing Co. Ltd., 1981. 361 pp., £ 7.50.
Reference guide to the corporation tax as amended by the Finance Act 1981.
(B. 103.627)

DI PALMA, Vera
Capital gains tax. Fifth edition.
The M & E Handbook series.
Plymouth, Macdonald & Evans, 1981. 208 pp., £ 4.50.
Handbook explaining capital gains tax as updated to include the provisions of the Finance Act 1981.
(B. 103.647)

TINGLEY, K.R.
Key to capital gains tax.
Finance Act 1981 Edition.
Taxation Master Key Series.
London, Taxation Publishing Co., Ltd., 1981. 441 pp., £ 7.50.
Reference guide describing the capital gains tax, based on law and practice as amended by the Finance Act 1981, stating the law as in force as of 1 September 1981.
(B. 103.629)

STANLEY, Oliver
Taxation of farmers and landowners.
London, Butterworths, 1981. 354 pp., £ 14.00.
Monograph on the United Kingdom taxes to which farmers and landowners are likely to be liable. It sets out the law and practice of income tax, corporation tax, capital gains tax, capital transfer tax, development land tax, value added tax, stamp duty and local authority rates.
(B. 103.551)

ROWLAND'S TAX
Guide 1981-82.
Editors: Nigel Eastaway, David Trill, Leslie Livens. Fifth edition.
London, Butterworths, 1981. 850 pp., £ 20.00.
Tax guide as an adjunct to Butterworths Yellow and Orange Tax Handbooks containing current legislation. It is essentially a brief explanation of the Tax Handbooks covering the income tax, corporate tax, capital gains tax, capital transfer tax and development land tax. The law is stated as of 1 August 1981.
(B. 103.585)

WILSON, David; DANIELS, Patrick D.
Business operations in the United Kingdom.
Foreign income portfolios.
Washington, Tax Management, 1981.
Detailled analysis and information for foreign businesses to determine the best method of conducting operations in the United Kingdom both from the tax and business points of view.
Loose-leaf service.
(B. 103.527)

TINGLEY, K.R.
Key to the new stock relief.
Finance Act 1981 Edition.
Taxation Master Key Series.
London, Taxation Publishing Co., Ltd., 1981. 122 pp., £ 6.00.
Reference guide describing the new stock relief as amended by the Finance Act 1981, stating the Law as in force on 1 September 1981.
(B. 103.628)

COOPER, J.M.
Key to income tax.
Finance Act 1981 edition.
Taxation Master Key Series.
London, Taxation Publishing Co., Ltd., 1981. 264 pp., £ 6.50.
Reference guide to the individual income tax as amended by the Finance Act 1981, stating the law as in force on 1 September 1981.
(B. 103.630)

EASTAWAY, Nigel; GILLIGAN, Brian
Tax and financial planning for professional partnerships.
London, Butterworths, 1981. 273 pp., £ 11.00.
Tax planning considerations for medium-sized and small partnerships.
(B. 103.542)

MELLOWS, Anthony R.
Taxation for executors and trustees.
Fifth edition.
London, Butterworths, 1981. 428 pp., £ 20.00.
Fifth edition of monograph following chronologically the phases in which an executor and trustee may be concerned with income tax, capital gains tax, development land tax and capital transfer tax. The law is stated as of 1 May 1981, but the provisions of the Finance Act 1981 are included.
(B. 103.544)

IND, Ronald C.
Capital transfer tax.
Revised by Martyn H. Jones. Second edition.
The M & E Handbook series.
Plymouth, Macdonald & Evans, 1981. 326 pp., £ 4.95.
Handbook explaining the capital transfer tax. The law is stated as of 31 July, including the Finance Act 1981.
(B. 103.648)

HART, Gerry
Dictionary of Taxation.
Butterworths Professional Dictionaries Series.
London, Butterworths, 1981. 236 pp., £ 10.00.
Definitions of tax words and phrases covering income tax, corporation tax, development land tax and value added tax.
(B. 103.584)

INTERNATIONAL

International

TAX ASPECTS OF ACQUISITIONS and Mergers.
Edited by Philip Cooke and Jan M. van der Beek.
Deventer, Kluwer, 1980. 148 pp., 70 Dfl.
Compilation of country studies by various contributors dealing in a comparative way with the taxation and other related aspects of acquisitions and mergers, both at the domestic level and cross-frontier. The countries covered are Belgium, Canada, Denmark, France, Ireland, Italy, the Netherlands, Spain, the United Kingdom, the United States and the German Federal Republic.
(B. 103.523)

DOGGART, Caroline
Tax havens and their uses 1981.
EIU Special Report No. 105.
London, The Economist Intelligence Unit, 1981. 138 pp.
Report pointing out the burden of taxation and the multitude of tax havens that have grown up to ease the weight of this burden.
(B. 103.552)

MODEL CONVENTION FOR mutual administrative assistance in the recovery of tax claims.
Report of the OECD Committee on Fiscal Affairs.
Paris, Organisation for Economic Co-operation and Development, 1981. 64 pp.
English text of the Model Convention for mutual administrative assistance in the recovery of tax claims followed by commentaries on the articles of the model convention and recommendations. A French edition of this report is available.
(B. 103.549)

TAXATION OF THE INCOME arising from the international seabed.
IFA Seminar Paper.
Deventer, Kluwer, 1981. 81 pp.
Introduction by Charles M. Bruce to tax issues resulting from the Draft Convention on the Law of the Sea and recently enacted U.S. and German Federal Republic internal laws. The text of the Draft Convention on the Law of the Sea is appended.
(B. 103.539)

THE IMPACT OF THE NEWLY industrialising countries on production and trade in manufactures.
Updating of selected tables from the 1979 Report by the Secretariat of the OECD.
Paris, OECD, 1981. 51 pp., $ 12.
Bilingual study in English and French updating selected tables from the 1979 Report by the Secretariat of the OECD on the impact of the newly industrialising countries on production and trade in manufactures.
(B. 103.443)

THE POLITICAL ECONOMY of Taxation. Edited by Alan Peacock and Francesco Forte.
Oxford, Basil Blackwell Publisher, 1981. 211 pp., £ 14.00.
Compilation of articles by various authors arranged in three parts: "Analytical Background", "Economic Aspects of Contemporary Tax Policy" and "Administrative Aspects of Contemporary Tax Policy".
(B. 103.519)

MIDDLE EAST

Israel

KLIMOWSKY, Ernst W.
Das israelische Aktienrecht.
Ausländische Aktiengezetze. Band 16.
Frankfurt, Alfred Metzner, 1981. 187 pp.
Introduction and translation into German of the Israeli company law.
(B. 51.846)

Saudi Arabia

TOWNSEND, John
Saudi Arabia. Issues for growth. An inside view of an economic power in the making.
New York, Business International S.A., 1981. 273 pp.

Research report describing the anatomy and political dimension of the Saudi economy, which also focuses on all aspects of doing business with Saudi Arabia. Text of foreign capital investment code, 1979 is appended.
(B. 51.794)

Loose-Leaf Services

Received between 1 January and 31 January 1982.

Australia

AUSTRALIAN INCOME TAX – LAW AND PRACTICE

- Cases
  release 40-44
- Current taxation
  release 10

Butterworths, Pty., Ltd., Chatswood

Belgium

DOORLOPENDE DOCUMENTATIE INZAKE BTW/LE DOSSIER PERMANENT DE LA TVA

release 132
Editions Service, Brussels.

FISCALE DOCUMENTATIE VANDEWINCKELE

Tome II, releases 40 and 41
Tome IV, releases 60-62
Tome V, release 49
Tome VII, release 44
Tome IX, release 123
Tome XIV, release 144
Tome XV, release 21
CED-Samson, Brussels.

GUIDE FISCAL PERMANENT

releases 430 and 431
Editions Service, Brussels.

GUIDE PRATIQUE DE FISCALITE

Tome I, release 41
Tome III, release 38
CED-Samson, Brussels.

VAKCURSUSSEN

release 131
Ministère des Finances, Brussels.

WETBOEK BELASTINGEN OVER DE TOEGEVOEGDE WAARDE

release 23
Ministère des Finances, Brussels.

Canada

CANADA INCOME TAX GUIDE REPORTS

release 166
CCH Canadian Ltd., Don Mills.

CANADA TAX SERVICE-RELEASE

releases 361-364
Richard de Boo Ltd., Toronto.

CANADIAN CURRENT TAX

releases 46-52
Butterworths, Pty., Ltd., Scarborough.

CANADIAN SALES TAX REPORTS

release 169
CCH Canadian Ltd., Don Mills.

CANADIAN TAX REPORTS

releases 511-515
CCH Canadian, Ltd., Don Mills.

DOMINION TAX CASES

releases 33, 1 and 2
CCH Canadian, Ltd., Don Mills.

FOREIGN INVESTMENT IN CANADA

releases 85 and 86
Prentice-Hall of Canada Ltd., Scarborough.

PROVINCIAL TAXATION SERVICE

releases 392 and 393
Richard de Boo, Ltd., Toronto.

Common Market (EEC)

DROIT DES AFFAIRES DANS LES PAYS DU MARCHE COMMUN

release 135
Editions Jupiter, Paris.

HANDBOEK VOOR DE EUROPESE GEMEENSCHAPPEN:

- Europese mededingings- en kartelrecht
  releases 62 and 63
- Kommentaar op het EEG-, Euratom- en EGKS-verdrag; verdragsteksten en aanverwante stukken
  release 222

Kluwer, Deventer.

Denmark

SKATTEBESTEMMELSER:

- Skattenyt
  release 144
- Skattebestemmelser
  release 138

A.S Skattekartoteket Informationskontor, Copenhagen.

France

BULLETIN DE DOCUMENTATION PRATIQUE DE SECURITE SOCIALE ET DE LEGISLATION DU TRAVAIL

release 13
Editions Francis Lefebvre, Levallois-Perret.

DICTIONNAIRE PERMANENT – DROIT DES AFFAIRES

release 89
Editions Législatives et Administratives, Paris.

DICTIONNAIRE PERMANENT – FISCAL

releases 124 and 125
Editions Législatives et Administratives, Paris.

JURIS CLASSEUR – CHIFFRE D'AFFAIRES – COMMENTAIRES

release 6110
Editions Techniques, Paris.

JURIS CLASSEUR – DROIT FISCAL – COMMENTAIRES – IMPOTS DIRECTS

release 1128
Editions Techniques, Paris.

German Federal Republic

DEUTSCHE GESETZE

Schönfelder
release 59
C.H. Becksche Verlagsbuchhandlung, Munich.

DOPPELBESTEUERUNG KORN – DIETZ – DEBATIN

release 43
C.H. Becksche Verlagsbuchhandlung, Munich.

RECHTS- UND WIRTSCHAFTSPRAXIS STEUERRECHT

release 264
Forkel Velag, Stuttgart.

STEUERERLASSE IN KARTEIFORM

release 244
Verlag Dr. Otto Schmidt, Cologne.

STEUERGESETZE

release January
C.H. Becksche Verlagsbuchhandlung, Munich.

STEUERRECHTSSPRECHUNG IN KARTEIFORM

release 360
Verlag Dr. Otto Schmidt, Cologne.

WORLD TAX SERIES – GERMANY REPORTS

release 150
Commerce Clearing House, Inc., Chicago.

International

STEUERN IN EUROPA, USA, KANADA UND JAPAN

von Mennel
releases 2 and 3
Neue Wirtschaftsbriefe, Herne/Berlin.

Netherlands

DE BELASTINGGIDS

release 94
S. Gouda Quint – D. Brouwer, Arnhem.

EDITIE VAKSTUDIE BELASTINGWETGEVING:

– Gemeentelijke Belastingen e.a.
  release 50
Kluwer, Deventer.

FED'S FISCAAL REGISTER

release 106
FED, Deventer.

FED LOSBLADIG FISCAAL WEEKBLAD

releases 1856-1859
FED, Deventer.

FISCALE WETTEN

releases 110 and 111
FED, Deventer.

HANDBOEK VOOR DE IN- EN UITVOER:

– Belastingheffing bij invoer
  releases 283 and 284
– Algemene wetgeving
  release 113
Kluwer, Deventer.

KLUWERS FISCAAL ZAKBOEK

release 173
Kluwer, Deventer.

KLUWERS SUBSIDIEBOEK

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Kluwer, Deventer.

KLUWERS TARIEVENBOEK

releases 249-251
Kluwer, Deventer.

MODELLEN VOOR DE RECHTSPRAKTIJK

release 74
Kluwer, Deventer.

NEDERLANDSE BELASTINGWETTEN

W.E.G. de Groot
release 178
Samson, Alphen aan de Rijn.

NEDERLANDSE WETBOEKEN

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Kluwer, Deventer.

RECHTSPERSONEN

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Kluwer, Deventer.

STAATS- EN ADMINISTRATIEF-RECHTELIJKE WETTEN

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Kluwer, Deventer.

VAKSTUDIE – FISCALE ENCYCLOPEDIE:

– Algemeen deel
  releases 103-106
– Inkomstenbelasting 1964
  releases 338-342
– Loonbelasting 1964
  releases 232-234
– Omzetbelasting 1968
  release 83
– Vennootschapsbelasting 1969
  release 94
– Investeringsregelingen
  release 30
Kluwer, Deventer.

Spain

MANUAL DE LA ADMINISTRACION

release December 1981
T.A.L.E., Madrid.

United Kingdom

BRITISH TAX GUIDE

release 234
Commerce Clearing House, Inc., Chicago.

SIMON'S TAX CASES

releases 1-3
Butterworth & Co., London.

SIMON'S TAXES

release 51
Butterworth & Co., London.

SIMON'S TAX INTELLIGENCE

releases 50, 1-3
Butterworth & Co., London.

United States

FEDERAL TAXES – REPORT BULLETIN

releases 2-5
Prentice-Hall, Inc., Englewood Cliffs.

FEDERAL TAX GUIDE

releases 13-15
Prentice-Hall, Inc., Englewood Cliffs.

FEDERAL TAX GUIDE REPORTS

releases 11-15
Commerce Clearing House, Inc., Chicago.

FEDERAL TAX TREATIES – REPORT BULLETIN

release 12
Prentice-Hall, Inc., Englewood Cliffs.

STATE TAX GUIDE

releases 759 and 760
Commerce Clearing House, Inc., Chicago.

TAX IDEAS – REPORT BULLETIN

releases 1 and 2
Prentice-Hall, Inc., Englewood Cliffs.

U.S. TAXATION OF INTERNATIONAL OPERATIONS

releases 22 and 24
Prentice-Hall, Inc., Englewood Cliffs.

THE EUROPEAN UNION

On 24 and 25 February 1982 the recently installed Institutional Committee of the European Parliament met with a view to organising its work which will eventually result in a draft for a Treaty to establish a European Union replacing the present forms of European cooperation such as the European Communities, political cooperation and the EMS. It is intended that the European Parliament will adopt a proposal for a European Union which will then be submitted for ratification to the national authorities.

Mr. A. Spinelli submitted a working document to serve as a basis for a preliminary discussion and which, among other things, will enable the "coordinating rapporteur" to prepare a draft resolution on guidelines for subsequent work.

The working document lists a number of tasks which the European Union should fulfill, including: the pursuance and development of the aims set out in the Treaties of Rome and Paris, the development of economic and monetary union, combatting inflation and unemployment, contributing to the harmonious social and economic development of the world as a whole, and maintaining the greatest possible degree of openness and stability in the world economy with regard to trade and monetary matters.

The European Union will, of course, need financial means and the working document states with respect to taxation:

> In accordance with appropriate agreed procedures, the Union and the Member States shall from time to time effect a redistribution inter se of their respective powers of taxation on the basis of the general plan for the Union's development as accepted in principle by the Member States.
> — Within the limits of the distribution of powers thus agreed the Union and States shall determine their taxes and budgets independently.
> — While it is in general desirable that the same tax collecting body shoud collect both national taxes and Union taxes, the respective accounting systems must be kept strictly separate so as to put an end to the present practice under which certain items of Community revenue are made to pass through national budgets.
> — Within the limits of the distribution of powers thus agreed, the Union's taxation and budget shall be proposed by the Government, adopted by Parliament, submitted to the Council – which may propose amendments supported by reasons or reject them by a simple majority of votes – and adopted at a second and final reading by Parliament.

Conference Diary

APRIL 1982

Management Centre Europe: International Tax Conference (including: Organisation of international groups; Selected tax aspects of international business planning; Governmental attitudes towards business in the tax field: the carrot and the stick). Nice (France), April 5-7 (English).

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

Oyez-International Business Communications Ltd.: The world is your tax haven (Three one-day seminars). Amsterdam (The Netherlands), April 26 (English); Bruxelles (Belgium), April 29 (English); Paris (France), May 4 (English).

MAY 1982

Management Centre Europe: Leasing in the 80's (including: The harmonisation of taxes in the E.E.C. and relevance for leasing). Brussels (Belgium), May 5-7 (English).

Seminar Services International: International Tax Planning (including: Use of tax treaties and tax treaty developments; legislation to counter use of tax havens and U.K. draft legislation on international tax avoidance). Amsterdam (the Netherlands), May 12-13 (English).

AMR International: Subcontracts and joint ventures in the Middle East, the legal and financial issues (including: Taxation and the Subcontractor). London (United Kingdom), May 13-14 (English).

International Tax Planning Association: 8th Annual Conference (including: The U.S. tax haven report; international tax planning for entertainers and athletes; taxes on non-residents; anatomy of a tax haven). Florence (Italy), May 19-21 (English).

Management Centre Europe: International cash management (including: International tax aspects in cash management). Nice (France), May 24-26 (English).

The Inter-American Center of Tax Administrators (C.I.A.T.): XVIth General Assembly on the basic subject Non-tax compliance. Asunción (Paraguay), May 24-28 (Spanish, English, French and Portugese).

Institute for International Research: The Zürich International Corporate Finance Conference (including: Legal, accounting and tax issues of different hedging forms; tax leveraging). Zürich (Switzerland), May 24-26 (English).

JUNE 1982

Management Centre Europe: Taxation of international group companies and branches (Seminar). Brussels (Belgium), June 3-4 (English).

Seminar Services International: Taxation of international financial transfers (including: The taxation of foreign currency gains and losses; The revaluation of foreign assets on the balance sheet; Operating holding and finance companies in the Netherlands and the Netherlands Antilles; Double tax agreements and disclosure agreements between tax authorities). Amsterdam (the Netherlands), June 9-10 (English).

Georgetown University Law Center: The Fourth Annual Institute on Multinational Taxation (including: Current developments in international tax rules outside the U.S.; Tax treaties – the changing landscape). Washington, D.C., (U.S.A.), June 24-25 (English).

SEPTEMBER 1982

36th Annual Congress of I.F.A.: I. The tax treatment of interest in international economic transactions. II. Taxation of payments to non-residents for independent personal services. Montreal (Canada). September 12-16 (English, French, German, Spanish).

Confédération Fiscale Européenne (C.F.E.): Third European Congress of Tax Consultants (including: State of tax harmonisation in Europe; The application of wealth taxes and taxes arising on death to foreign assets and liabilities; The practical application of international tax provisions (working groups)). Aix-la-Chapelle (France), September 30 to October 2 (English, French, German).

OCTOBER 1983

37th Annual Congress of I.F.A.: I. Tax avoidance/tax evasion. II. International problems in the field of turnover taxation. Venice (Italy), October 10-15 (English, French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

AMR International: 6-10 Frederick Close, Stanhope Place, London W2 2HD (United Kingdom).

Confédération Fiscale Européenne (C.F.E.): Secrétariat Général, Postfach 1340, Dechenstrasse 14, D-5300 Bonn 1 (Federal Republic of Germany).

Georgetown University Law Center: 600 New Jersey Avenue, N.W. Washington, D.C. 20001 (U.S.A.).

Inter-American Center of Tax Administrators (C.I.A.T.): Executive Secretary of C.I.A.T., P.O. Box 215 zona 1, Panamá.

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).

Institute for International Research: 70 Warren Street, London W1P 5PA (United Kingdom).

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

Oyez-International Business Communications Ltd: Norwich House, 11-13 Norwich Street, London EC4A 1AB (United Kingdom). French residents should register with Euroforum, 16 Place Vendome, 75001 Paris (France).

Seminar Services SA: 1 passage Perdonnes, CH-1005 Lausanne (Switzerland).

CUMULATIVE INDEX 1982 - Nos. 1 & 2

Taxes and Humor

The Municipality of São Paulo enacted Law No. 9,322 of 25 September 1981 exempting from the tax on services (Imposto sobre Serviços de Qualquer Natureza) the individual performances of Brazilian humorists.

The measure met the "serious" objection of being discriminatory because it favors only a particular kind of theatrical spectacle, and is thus detrimental to similar activities which are facing difficulties in providing a bit of "culture".

Besides (the comment goes on) rather than look for a cheaper laugh for the people, an exemption should be provided to lower the cost of the health services.

Some questions arise: is laughter important?, how important is it?, can it be encouraged with tax incentives?

Source: Imposto Fiscal, No. 572, Publicações Associadas Paulista Ltda., São Paulo, 20/10/1981, page 1493.

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THE PERUVIAN TAX REFORM (1981)

by Pedro Massone*

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I. INTRODUCTION

During 1980, the Peruvian government appointed a National Commission for Tax Reform composed of Drs. Roberto Dañino Zapata, General Secretary of the Ministry of Economy, Benedicto Cigueñas Guevara, Under Minister of Finance, and Armando Zolezzi Moller, General Director of Taxes.

In addition, Law No. 23,230, enacted on 15 December 1980 under Article 188 of the Political Constitution of Peru, vested the Executive Branche with the authority to issue Legislative Decrees referring to taxes and other subjects.

On the basis of the work developed by the National Commission for Tax Reform and using its delegated authority, the Peruvian Government enacted several legislative decrees introducing new legislation regarding income tax, sales taxes, mining and other subjects.

The new legislation includes the following acts:

(1) Legislative Decree No. 200 of 12 June 1981 introducing an entirely new income tax law (Ley General de Impuesto a la Renta), which contains changes concerning tax jurisdiction, allowable deductions, tax rates, reorganization of companies, etc.;

(2) Legislative Decree No. 190 of 12 June 1981 introducing an entirely new sales tax law, which contains changes concerning the coverage of the sales tax, tax rates, tax credits, excise taxes and a special tax on goods which Peru traditionally exports ("traditional goods");

(3) Legislative Decree No. 213 of 12 March 1981 introducing amendments to the net worth tax that include provision for the avoidance of economic double taxation and the measurement of brackets in tax units (see II.E. below);

(4) Legislative Decree No. 184 of 12 June 1981 introducing rules on a betterment contribution;

(5) Legislative Decree No. 187 of 12 June 1981 introducing amendments to the Tax Code of 1966 as regards the Fiscal Court and other subjects;

(6) Legislative Decree No. 109 of 12 June 1981 introducing an entirely new General Mining Law, which contains rules on mining taxation and tax incentives; and

(7) other rules on tax evasion, tax amnesty, and various other subjects.

From this brief survey, it is easy to realize that the reform deals with many subjects and refers to a number of laws which cannot be covered in detail within the limits of an article. It is, therefore, convenient to restrict the scope of this work to the most relevant aspects of the reform, that is to say, the principal features of the taxation of business income, taxation of particular types of income (e.g. income from mining, other income specially taxed, investment income and income derived by non-domiciliaries) and sales taxes.

Such topics as income taxation of individuals, net worth tax, betterment contribution and tax code will not be considered.

* Professor of Tax Law at the University of Valparaíso.

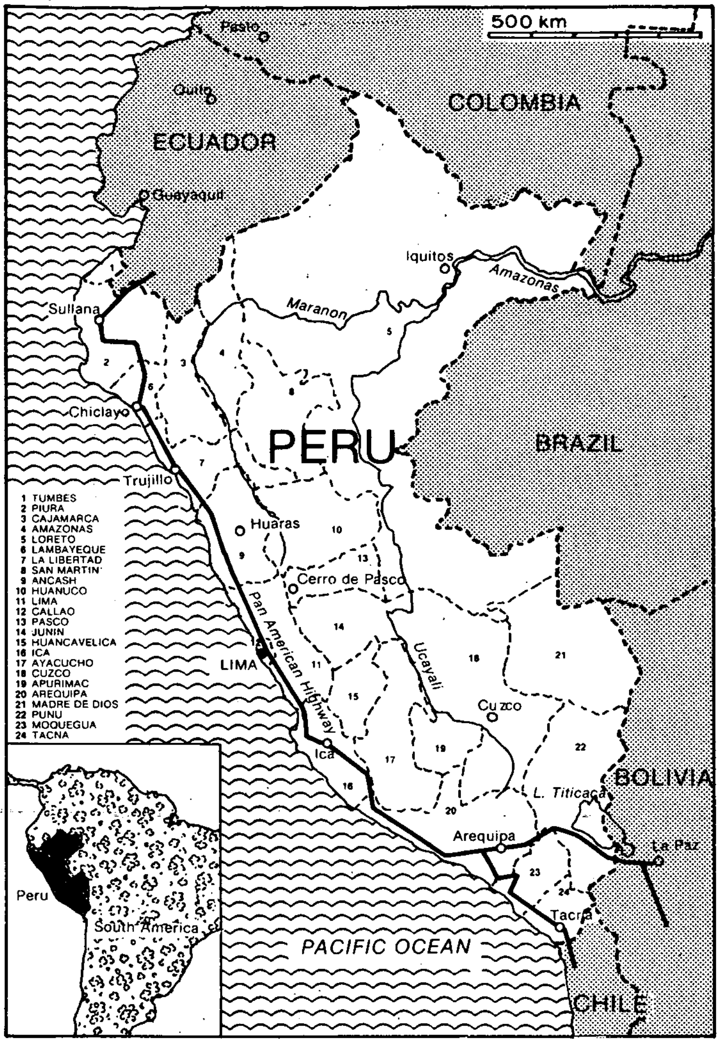

Chart by Van Pelt – Amsterdam

II. TAXATION OF BUSINESS INCOME

A. General description

Originally, the Peruvian income tax system was principally schedular. Later on, Supreme Decree No. 287-68-HC of 13 August 1968 introduced a change-over from the schedular to a global system and consequently its regulations provided for assessment on the aggregate income of the taxpayer whether he was a natural or a juridical person. This approach was confirmed by the new income tax law enacted with Legislative Decree No. 200 of 12 June 1981.

In fact, except for rates and a few special standards (e.g. personal allowances), the income tax is levied under rules which are the same for individuals and legal entities.

The new income tax law enters into force as from taxable year 1982 (assessment year 1983) and is applicable to taxable periods starting on or after 1 January 1982.

The old income tax law included in Supreme Decree No. 287-68-HC, its complementary legislation, regulations thereto and any provision referring to income taxation or which is in conflict with the new law is revoked. However, exemptions, allowances, other tax benefits, tax credits referred to in Decree-Law No. 22,401,[1] amendments thereto, laws pertaining to certain sectors of activity and laws stimulating the economy are not revoked and remain in force.

B. Taxable persons

The income tax law is levied, on individuals, married couples, undivided inheritances and legal entities.[2]

For income tax purposes, legal entities include only:
- corporations organized in Peru;
- partnerships organized in Peru and limited by shares, in that proportional part corresponding to stock shares;
- cooperatives;
- enterprises belonging to the social property (i.e. unions and similar organizations);
- state-owned enterprises;
- mining and oil enterprises irrespective of their legal organization;
- charities, societies, industrial, fishing and mining communities as regards the taxable income;
- sole proprietorships, companies and entities of any kind organized outside Peru, which derive Peruvian-source income;
- branches or agencies in Peru of sole proprietorships, companies and entities of any kind organized outside Peru; and
- agricultural companies of social interest, and cooperatives for agricultural production.

Income derived by sole proprietorships, commercial limited liability companies and other companies not considered to be legal entities under the rules discussed above, inclusive of the income belonging to the general partners of a partnership limited by shares, is attributed to the owners or shareholders, irrespective of actual distribution. Likewise, income derived by de facto companies, joint ventures and property held in common is attributed to members thereof, irrespective of actual distribution.

C. The concept of income

1. General income concepts

The tax under consideration is levied on the income derived from capital, work, or the joint application of both factors, and also on earnings statutorily considered to be taxable income. Income from the following sources is specifically considered to be taxable:
- the assignment of property to a member upon his

1. Decree-Law 22,401 of 22 December 1978 provides a system of tax credits which replaces investment allowances as from the taxable year 1979.
2. The following persons and entities are exempt from the income tax:
- the government and agencies thereof (sector público), except for state-owned enterprises which are taxable;
- universities, educational and cultural centers;
- charities (fundaciones) duly organized under the law and provided they pursue statutorily any of the following aims: education, culture, advanced research, charity, social and health assistance and social benefits for the personnel of enterprises;
- mutual assistance entities; and
- peasant and indigenous entities (communidades campesinas y nativas).

withdrawal from a business association or upon total or partial dissolution thereof. The income arising from the assignment is taxed with the association;[3]
- the transfer of goods carried out within 2 years as of the termination of activities performed by a business enterprise.

Taxable income also includes the following items:
(1) any compensation paid to an enterprise under insurance contracts covering its personnel and any compensation not covering real damage;
(2) any difference between premiums or contributions paid by insured persons and sums paid by insurance companies upon maturity of life insurance policies providing a dowry or other benefits paid on life insurance policies;
(3) royalties;
(4) capital gains arising from the transfer of specified property;[4] and
(5) results from the habitual sale, exchange or transfer of goods.

For computation purposes, income is classified into the following categories:
- *first category*, including income from real property;
- *second category*, including other capital income (dividends, interest, royalties, etc.);
- *third category*, including income from commerce, industry, business and similar sources;
- *fourth category*, including income from professional services (fees and remuneration of board members); and
- *fifth category*, including income from employment (wages, salaries and participation in profits).

Income derived by legal entities and enterprises domiciled in Peru is included in the third category irrespective of its nature. Moreover, income not specifically included in another category is deemed to be third category income.

2. Tax jurisdiction

The income tax is levied on Peruvian-source income only, irrespective of the nationality of individuals and the country where legal entities are organized.[5]

The following items of income are considered to be from Peruvian sources:
- income from real estate located in Peru;
- income from capital, assets or rights located or used for economic activities in Peru;
- income received with respect to personal services performed in Peru;
- profits derived from civil, commercial and other activities carried out in Peru; and
- income from the transfer of shares or participations in the capital of enterprises or companies organized in Peru.

The following items are also considered to be Peruvian-source income:
- interest, commissions, premiums and any sum paid for loans, financing or, in general, for any capital placed in Peru;
- interest on debts, when the debtor-company has been organized in Peru;
- wages and any remuneration paid or credited by enterprises domiciled in Peru to members of administrative boards performing activities abroad;
- royalties; [6] and
- fees or remuneration paid by the Peruvian government and agencies thereof (Sector Público Nacional) to persons performing representative or official duties abroad.

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 foreign-source income.

3. Taxable period and allocation rules

For income tax purposes, the taxable period runs from 1 January to 31 December. The same rule applies to the commercial period but the tax administration may, upon request, authorize a different closing date for activities and businesses having special characteristics.

Items of income are allocated to taxable periods under the following rules:
(1) third category income (i.e. business income) is deemed to be produced in the commercial period during which it arises. The income belonging to legal entities shall then be included in the taxable period during which the corresponding commercial period is closed. Likewise the income originating from sole proprietorships or from partnerships not considered to be legal entities for income tax purposes shall be allocated by the owner or partner to the taxable period during which the commercial period is closed;
(2) first category income (i.e. income from real property) shall be allocated to the taxable period during which it arises; and
(3) other income (i.e. non-specified income) shall be allocated to the taxable period during which it is collected.

The above rules shall be similarly applied to the allocation of expenses.

In the computation of third category it is possible to cosider expenses paid in the period but incurred in preceding periods. However, if the amount was known when incurred and no provision was made for payment, the late deduction shall be limited to 80% of the expense. If the amount of the expense was not known or anticipated when incurred, however, a full deduction may later be allowed by the tax administration.

Income from the transfer of goods in installments to be paid during periods exceeding one year as from the date of the transfer may be allocated to commercial periods during which installments are due for collection.

For income tax purposes, income which is at the beneficiary's disposal is deemed to be collected.

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3. For income tax purposes the value of the assignment cannot be less than the following minimums provided by the law:
- for inventories, the price of transactions made with third parties;
- for securities, their quotation in the stock market; and
- for fixed assets, the market value or, if transactions thereon are not frequent, the assessed value.

4. For the taxation of capital gains see Section III. D.1. below.
5. In the old income tax law, persons resident or domiciled in Peru were traxed on world-wide income.
6. The Peruvian law does not provide further specification.

4. Reorganization of companies

The income tax law includes some provisions that regulate and facilitate the reorganization of companies and enterprises. For these purposes a reorganization includes only mergers and split offs.

The provisions of the law are:
- the taxation of income arising from the appreciation of goods transferred as a result of the reorganization is deferred until distribution thereof;
- the value of the goods, transferred as a result of the reorganization are carried over to the acquirer. Likewise, the values on which depreciation is calculated and the useful life taken for these purposes shall not be changed as a result of the reorganization;
- losses incurred by the transferor can be offset against income derived by the acquirer, under the same terms existing prior to the reorganization; and
- organization and pre-operative expenses incurred by the transferor can be amortized by the acquirer under the same terms existing before the reorganization. The same rule applies to the amortization of the price paid for intangible assets.

D. The computation of taxable income

1. General description

The computation of taxable income is made through the following stages:
(1) gross receipts;
(2) net receipts;
(3) gross income;
(4) net income; and
(5) taxable income.

Net receipts from the transfer of goods are established by deducting, from gross receipts, refunds, bonuses, discounts and similar items, provided they are in accordance with market practices.

Gross income is defined as the aggregate of taxable proceeds arising in the taxable period. As regards proceeds from the transfer of goods, gross income is represented by net receipts minus deductible costs.

The cost of transferred goods is the acquisition or production cost or, as the case may be, the acquisition or inventory value established under the law. For property subject to depreciation, the cost is reduced by depreciation allowances.

For immovable property, the cost is calculated under the following rules:
- if the property has been acquired for a consideration, the cost is the acquisition value as adjusted for inflation under indexes established in regulations to the law;[7] and
- if the property has been acquired gratuitously, the cost is the cadastral value as adjusted for inflation under indexes established in regulations to the law.[8]

For shares and participations, the cost is calculated under the following rules:
- if the shares and participations were acquired for a consideration, the cost is the acquisition value; and
- if the shares and participations were acquired gratuitously, the cost is the market value or, if there is no market value, the cost is established under regulations to the law.[9]

In order to establish the *net income*, the expenses necessary to produce the income and to conserve its source may be deducted from gross income unless the deduction is specifically excluded. In the absence of proof to the contrary, it is presumed that expenses incurred abroad are related to foreign income and are consequently disallowed as a deduction.

The *taxable income* of legal entities is equal to their net income. The taxable income of individuals domiciled in Peru is equal to net income less specified personal deductions and allowances.

2. Specific deductions

It has been said that, in order to establish net income, the expenses necessary to produce the income or conserve its source may be deducted unless specifically excluded.

The law also provides that, under certain limits and conditions, the deduction of some items is specifically allowed in the computation of third category income (business profits), i.e. amortization, bad debts, collection expenses, depreciation, entertainment, fees, gifts, interest, leasing payments, losses, organization and pre-operative expenses, premiums, reserves, royalties, retirement pensions, salaries and other remuneration, social benefits, taxes and travel expenses.[10]

The following discussion shall cover only those specific deductions which have the most relevant interest within the group.

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7. Not received at the time this article was completed.
8. Not received at the time this article was completed.
9. Not received at the time this article was completed.
10. The law also specifies that the following items are not deductible in calculating taxable income:
(1) personal expenses of the taxpayer and his family;
(2) the income tax;
(3) fines, surcharges, interest for late payments and other penalties applied by the government and its agencies (sector público nacional);
(4) gifts other than those allowed as a deduction by the law;
(5) sums invested in the acquisition of assets or in permanent improvements;
(6) allocations to reserve funds which are not allowed as a deduction by the income tax law;
(7) amortization of intangible assets. However, the price paid for intangible assets can be fully deducted as an expense when incurred or amortized in up to 10 years;
(8) exchange losses sustained as regards that part of foreign financing which exceeds an amount equal to 3 times the net worth of the debtor. The limit can be changed by the government where not appropriate to the requirements of specific activities;
(9) interest paid to entities abroad that are economically connected with the debtor, in that part which is above the limit established in regulations to the law and interest on that part of financing which is above 3 times the net worth of the debtor. The rules do not apply where the limit has been amended by the government;
(10) trade commissions originating abroad for the purchase or sale of goods, in that part exceeding usual payments in the country where commissions originate;
(11) losses incurred in the sale of securities for the acquisition of which a tax incentive has been received; and
(12) taxes assumed by the payor of income which are due by the recipient thereof, except for the 10% tax levied on interest paid abroad under rules discussed in Section III. E.4. below.

a. *Depreciation*

Amounts representing depreciation allowances corresponding to fixed assets are deductible. Allowances are calculated annually and, if not taken in due time, may be deducted in subsequent periods.

The depreciation rate for buildings and structures is 3% per year. For other fixed assets used for the production of taxable income, depreciation rates are calculated at percentages established in accordance with their useful life. The percentages are then applied to the acquisition or production value of goods or to values resulting from revaluations made under the law. The value of permanent improvements must also be considered. Regulations can authorize that depreciation allowances be taken under other rules.

If personal property becomes obsolete or is no longer used, the taxpayer can go on taking depreciation allowances or take a full deduction of the balance in one single period.

b. *Entertainment*

Entertainment expenses belonging to the business are deductible for that part which, in the aggregate, does not exceed both 1% of gross receipts and the number of tax units specified in regulations to the law.[11]

c. *Fees*

Remuneration paid to members of a corporation's board of directors for the discharge of their duties is deductible up to a sum which, in the aggregate, does not exceed 6% of pre-tax business profits.

d. *Interest*

Interest and financing expenses are deductible provided they are incurred in order to acquire goods or services for the production of income in Peru or to protect its source. Taxpayers deriving interest and other income from financing which is free from income tax may deduct only interest and financing expenses that exceed tax-free income. This limit does not apply to interest derived from securities acquired to discharge an obligation established in the law or in the Central Bank rules, or from securities yielding an interest not above 50% of the rate established by the Central Bank for rediscount granted to commercial banks.

e. *Losses*

Taxpayers domiciled in Peru may set off the aggregate net loss incurred in a taxable period against net income arising during 4 successive years computed as of the first year showing profits. Any balance not so compensated cannot be carried forward.

In the computation of losses, exempt income and dividends must be taken into account (i.e. to reduce the loss or to eliminate it). By contrast, personal allowances of individuals (e.g. family allowances for spouse, children and dependents) are not taken into account to increase losses.

Taxpayers performing economic activities requiring large investments and long periods to consolidate production may enjoy longer periods to carry forward losses, under rules to be established in regulations.[12]

Extraordinary losses of assets devoted to the production of taxable income, as a result of acts of God, force majeure or crimes, are deductible provided the loss is not covered by compensation or insurance. The normal decrease in inventories is also deductible.

f. *Royalties*

Royalties are deductible under the rules established in regulations to the law.[13]

E. Tax rates

1. General rates

Resident legal entities are taxed at progressive rates ranging from 30 to 55% applied to brackets expressed in tax units,[14] as shown in the following chart:

Taxable income (tax units)	*Percentage levied on excess over lower limit*
0 - 150	30
150 - 1500	40
1500 - 3000	50
more than 3000	55

2. Surcharges

a. *Capitalization tax*

Profits capitalized by means of issuing stock dividends within 6 months from the closing date of the taxable year are subject to a 15% "capitalization" tax which must be paid within the first 15 days of the month following the month during which the capitalization is decided. This is a final tax excluding taxation on the relevant stock dividends and can be paid by the corporation out of undistributed profits or free reserves without further tax liability for the shareholder.

The relief attached to the capitalization tax[15] is not available during the 5 years following a capital reduction or if the tax is not paid in due time. Likewise, if the capitalization is carried out within 6 months and the capitalization tax is paid within the time limits as stated above but the corresponding company liquidates or distributes its capital within 5 years as from the date of the public deed containing the capitalization, then the difference between the 15% tax and the normal income tax on dividends will be due.[16]

Legal entities are not allowed to establish freely disposable reserve funds in excess of 100% of their paid-in capi-

11. Not received at the time this article was concluded.
12. Not received at the time this article was concluded.
13. Not received at the time this article was concluded.
14. The tax unit was introduced by Legislative Decree No. 7 of 30 December 1980 and is to be adjusted every year in accordance with changes in prices. For taxable year 1981 it is 350,000 Soles.
15. Recourse to the capitalization tax and the benefits attached thereto involve a tax relief in the sense that in the absence thereof the 25% withholding tax on dividends would be due.
16. The normal tax on dividends is currently 25%.

tal. Any sum above the limit which is also above 2 tax units must be compulsorily capitalized or distributed within 12 months as from the date of the balance sheet in which the excess appears.

If the capitalization is carried out within 6 months as from the closing date, the capitalization tax and the benefits attached thereto apply.

If the capitalization and/or distribution are carried out after 6 months but within 12 months as from the closing date of the taxable year, the 25% tax on dividends is due upon distribution. However if the capitalization or distribution is not carried out within 12 months as from the closing date, the sum exceeding 100% of paid-in capital shall be subject to the 25% withholding tax on dividends, surcharges and interest as if distributed to shareholders, irrespective of actual distribution.[17]

b. *Additional rate (tasa adicional)*

There are certain specific instances where non-compliance with the tax law is penalized with an additional rate of tax (tasa adicional). In fact, the following items shall be subject to an additional rate of 40%:

- any sum registered as an expense which later on is discovered to be really taxable income;
- any sum charged to profits or to freely disposable reserves, provided it represents an indirect disposal of income which has escaped tax control; and
- any sum which upon a tax control is assessed as income and which has not been reported in tax returns.

The additional rate is not applicable to income derived by branches or agencies (see Section III. E. 2. below).

F. Income tax administration

1. Annual returns and payments

Individuals, married couples, undividend inheritances and legal entities deriving income subject to tax must file an income tax return not later than 30 April of every year, including additional information on net worth, as may be requested.

Branches and agencies in Peru of individuals or legal entities domiciled abroad must also file returns showing the income available for the non-domiciliary.

Sole proprietorships, individual enterprises with limited liability and partnerships not treated as legal entities for income tax purposes shall file, after the closing of the commercial period and under terms and requirements established in regulations,[18] a return showing the net income or loss of the commercial period; this income or loss shall be attributed to the owners or partners proportionally to their participation in the enterprise's capital.

The tax due in accordance with the income tax return must be paid at official or private banks before the filing thereof. The tax corresponding to income in foreign currency shall be paid in Peruvian currency. For this purpose, the income in foreign currency must be converted into Peruvian currency in accordance with the exchange rate at the date on which income arises or is collected, as the case may be.[19]

2. Tax prepayments

In addition to annual returns and payments, taxpayers are required to make monthly prepayments which are creditable against the final liability to income tax.

For calculating the monthly prepayments, legal entities can choose one of the following methods:

(1) pay for each of the first 2 months of the period 10% of the income tax paid in the second preceding taxable year and pay for the remaining months of the period a portion of the tax paid in the preceding year to be established under rules enacted every year by the Finance Ministry;
(2) calculate the monthly prepayment on the basis of a balance sheet showing the income of the corresponding month; or
(3) pay 2% of third category gross receipts arising in the month.

If the legal entity fails to choose one of the methods, the tax administration shall calculate and charge the prepayment under methods (1) or (3), as it may prefer.

Likewise, the income tax law offers individuals several alternatives for the computation of the amount of prepayments (not covered in this article).

3. Tax audits

If an annual income tax return is not filed, the tax administration shall require the taxpayer to prepare it and to pay any tax due, inclusive of surcharges and interest, within 30 days. If after that term the taxpayer does not satisfy the requirement, the tax administration may, without further delay, charge and compulsorily collect a sum equal to the rax of the last period for which a return or assessment exists, multiplied by the number of delinquent periods, plus surcharges and interest. In these cases, the taxpayer's rights are limited to refund claims for excessive collection.

Besides the steps mentioned above, the tax administration may estimate the taxpayer's income and, for that purpose, use any of the following techniques:

- calculate the income by means of coefficients based on capital, the amount of transactions and income of other periods, the amount of purchases and sales, inventories of merchandise and products, bank deposits, normal business results of similar enterprises, salaries, rent and other overhead;
- calculate the income on the basis of external signs of wealth such as rent paid for dwellings, value of dwellings, value of estates used for entertainment, vehi-

17. Before the tax reform, industrial companies with receipts above 590 "annual minimum wages" for the Lima Province had to either pay a tax of 2% on after tax profits for scientific research or use a similar amount for scientific or research programs approved by the appropriate government agency (Instituto de Investigación Tecnológica Industrial y de Normas Técnicas). This levy is still in force after the tax reform because it originates from a special law which was not specifically amended by the reform.
Moreover, a surtax of 2% on behalf of the "Fondo te Compensación Nutricional" was levied on the full taxable profits of legal entities the profits of which were above 60 tax units (unidades impositivas tributarias). It might be understood that this last levy was revoked by the new income tax law. However, Law No. 23,337 of 15 December 1981 specifically extended its application to 1982.
18. Not received at the time this article was concluded.
19. For allocation rules, see Section II. C.3. above.

cles, boats, luxury horses, servants, travel abroad, social clubs, education, works of art, etc.;
- calculate the income on the basis of changes or increases in the taxpayer's capital and any other data available to the tax administration;
- use general averages and percentages for a certain product or branch. No proof shall be admitted to rebut said averages or percentages when the taxpayer has not filed his income tax return; or
- calculate the income on the basis of differences in stocks, averages of estimated receipts, market values and technical indexes provided in regulations to the law.[20]

For assessment purposes, it is presumed, with right of rebuttal, that any difference between expenses of an individual and reported income is unreported net income. Likewise it is presumed, without right of rebuttal, that any capital increase the origin of which cannot be justified by the taxpayer is unreported net income.

The income tax law includes a rule under which any audit performed by the tax administration must begin with the return corresponding to the last taxable period, provided one has been filed. If there is no objection to the return, the tax administration may not charge taxes due for previous periods. This standard does not apply if the last taxable period cannot be audited due to the taxpayer's fault.

When the income tax return of the last taxable period has been considered correct by the tax administration, but later on it appears not to be so, then the tax control can be extended to the periods which originally could not be covered because of the scheme.

III. TAXATION OF PARTICULAR TYPES OF INCOME

A. The concept of domiciliary

The new Peruvian income tax law contains some rules dealing specifically with the taxation of income belonging to non-domiciliaries, referred to below, especially in Section III. E. Domiciliaries and non-domiciliaries are defined in the followning manner.

For income tax purposes, the following are considered to be domiciled in Peru:
- Peruvian individuals who under the general law are domiciliaries of Peru;
- foreign individuals who have lived or been present in Peru for 2 successive years or more. Temporary absences not above 90 days in each taxable period are not taken into account;
- persons discharging abroad representative duties or official positions for the government or its agencies (sector público nacional);
- legal entities organized in Peru;
- branches, agencies and other permanent establishments in Peru belonging to individuals or legal entities not domiciled therein. In this case, the branch, agency or permanent establishment is considered to be domiciled in Peru only as regards its Peruvian-source income; and
- inheritances of persons who were at their death domiciliaries of Peru, under the income tax law.

Non-domiciliaries who have been present in Peru for 6 months and have been registered as taxpayers can elect to be treated as domiciliaries for income tax purposes.

On the other hand, individuals shall cease to be regarded as domiciliaries for income tax purposes, if they leave Peru and become residents of another country. Where it cannot be proved that an individual has become a resident of another country, he shall be regarded as a domiciliary unless he is absent from Peru for 2 successive years or more. Temporary visits to Peru not lasting more than 90 days in each taxable period are not taken into account.

B. Taxation of income from mining

1. Taxation rules

The General Mining Law introduced by Legislative Decree No. 109 of 12 June 1981 regulates the exploitation of all mineral resources existing in Peruvian soil, subsoil or sea, except for petroleum, other hydrocarbons, guano deposits and medicinal mineral waters.[21]

In Peru, mineral resources are inalienable State property. Mining activities may be carried out by State-owned enterprises or, under government concessions, by private individuals and legal entities, either Peruvian or foreign. Concessions are irreversible as long as the concessionnaire complies with requirements established in the General Mining Law. The mining industry is considered to be of public interest.

The government may retain for the State exclusive mining rights on certain minerals or in certain areas (áreas de reserva nacional). The government can also establish special rights in favor of the State (derechos especiales del estado) and grant them to state-owned enterprises. The nature of the special rights is similar to that of concessions.

The law authorizes the establishment of "special mining enterprises" (empresas mineras especiales), that is to say, corporations with minimum state participation of 25%, organized under the General Mining Law with the purpose of carrying out mining activities protected by special rights in favor of the state or, as the case may be, by concessions granted to private persons. Individuals and legal entities, either Peruvian or foreign, can participate in the special mining enterprises.

Concessionnaires are subject to the payment of surface and registration duties. They are also required to make investments, carry out activities and reach production levels established in the law. Mining activities are subject to income tax but are exempt from other taxes.

The income tax is levied, as regards mining activities,

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20. Not received at the time this article was concluded.
21. Under Decree-Law No. 17,440 of 19 February 1969, petroleum and other hydrocarbon deposits are State property, and petroleum and petrochemical industries are public services. Law No. 23,231 of 26 December 1980 permits the state-owned company Petroperu to grant secondary and tertiary petroleum recovery operations to foreign firms. Previously this practice was disallowed.
Decree-Law No. 22,775 of 6 December 1979, as amended by Decree-Law 22, 862 of 5 January 1980, established a new regime for oil contracts and introduced tax rules applicable to oil contractors and to Petroperu.

under ordinary rules of the Income Tax Law, with the following deviations:

- Income derived and losses incurred by partnerships limited by shares (for that part belonging to general partners), commercial limited liability companies, general partnerships, limited partnerships, mining limited liability companies, special mining enterprises and any form of enterprises receiving tax incentives granted in contracts entered into with the government under Article 157 of the General Mining Law[22] are allocated to partners proportionally to their participation in the entity's capital.

  Under this scheme, the taxpayer is the partner. The income tax paid by the company is considered to be a prepayment to be credited against the partners' liability up to the limit of that liability and proportionally to the partners' shares in the company's capital. Moreover, the liability to the income tax arising for individuals from mining activities is limited to the tax resulting from the application of ordinary rates to mining income only (i.e. as separate from other income).

- The acquisition value of mining rights and that of special rights of the state shall be amortized as from the period during which the production minimum becomes compulsory.
  For amortization purposes, the acquisition value includes the acquisition price or the registration cost, as the case may be, and prospecting and exploration expenses incurred up to the date on which a production minimum becomes compulsory.[23] The amortization is to be spread over a period determined by the taxpayer considering the deposit's life as calculated in accordance with the mineral reserves and the production minimum already referred to.[24]
- Exploration expenses incurred as from the date the production minimum established in the law becomes compulsory can be fully deducted or amortized using an annual percentage which is determined considering the deposit's life as calculated in accordance with mineral reserves and the production minimum. Development and preparation expenses permitting the deposit exploitation for more than one period can be fully deducted in the period during which they are incurred or amortized in up to 3 periods including that one during which they are incurred.[25]
- Branches or foreign enterprises not domiciled in Peru receiving tax incentives granted in contracts entered into with the government under Article 157 of the General Mining Law[26] may remit abroad an amount equal te depreciation allowances taken on fixed assets, capitalized expenses and profits, provided the balance sheet of the period shows a profit, or a loss which does not exceed depreciation allowances registered in the period. If losses exceed depreciation allowances of the period, remittances related thereto shall be reduced in an amount equal to the difference. Special mining enterprises and companies receiving tax incentives granted in contracts entered into with the government under Article 157 of the General Mining Law[27] that have among their partners one or more branches of foreign enterprises not domiciled in Peru shall, for remittance purposes, allocate depreciation allowances and amortizations among their partners proportionally to their share in the capital's.
- Any person performing mining activities shall contribute 1% of his after tax profits to the Geological and Metallurgical Institute (Instituto Geológico Minero Metalúrgico).

2. Tax incentives

The General Law on Mining grants several tax benefits for the promotion of mining activities. The incentives refer to depreciation and revaluation, investment and reinvestment, permanency of taxation rules, contracts with the government, and special rules.

a. *Depreciation and revaluation*[28]

Depreciation allowances for investments made by mining enterprises in machinery, equipment, installations, housing, social welfare, vehicles and earthworks, up to 300 tax units in the year, can be taken at a 100% rate.

Depreciation allowances of the same investments exceeding 300 but not 900 tax units in a year can be taken at a 20% rate except where the normal depreciation rate is higher. Depreciation allowances on that part of investments exceeding 900 tax units in the year are taken under ordinary rates for mining.

If the exchange rate of Peruvian currency against the American dollar changes by more than 5%, fixed assets can be revalued free from income and other taxes. Capitalization of the net balance of the revaluation (revaluation of assets less adjustment of debts incurred in foreign currency to buy the assets) is also free from taxation.

b. *Investment and reinvestment*

Mining enterprises are entitled to a tax credit if they reinvest in their own operations - or invest in other mining enterprises - in an amount not exceding 40% of their net income.

Persons not engaged in mining activities can also take advantage of the above credit, provided they make investments in mining enterprises. If the credit is not actually used by these persons, it can be taken by the enterprise receiving the investment. The above tax credit is calcu-

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22. This kind of contract is discussed in Section III. B.2.d. below.
23. The taxpayer can elect to deduct prospecting and /or exploration expenses in the period during which they are incurred.
24. If the mining rights are abandoned or revoked before the production minimum becomes compulsory, the acquisition value shall be fully deducted. If the mining rights are abandoned or revoked, or the mining deposit is depleted after the production minimum becomes compulsory but before the acquisition value has been fully amortized, the taxpayer can choose to deduct immediately the balance or go on with the amortization.
25. If the mining reserves are depleted or mining rights are revoked, the taxpayer can choose to deduct immediately the balance of expenses or go on with the amortization.
26. This kind of contract is discussed in Section III. B.2.d. below.
27. This kind of contract is discussed in Section III. B.2.d. below.
28. The provisions on depreciation allowances and revaluation discussed herein are not applicable where a contract has been entered with the government, under Article 157 of the General Mining Law.

lated by applying the average or effective income tax rate to the investment or reinvestment.[29]

In order to receive the benefits, it is necessary to prepare investment and/or reinvestment programs and obtain approval therefor from the government (Dirección de Fiscalización Minera).[30]

The investment program can be carried on directly by each separate enterprise or by means of joint ventures or legal entities organized for that purpose. Assets acquired under investment programs cannot be transferred before depreciation allowances representing 90% of their value have been taken without considering accelerated depreciation. It is, however, possible to transfer the asset to another mining enterprise which will not enjoy a credit for the sum invested in the acquisition.

The credit from investments belonging to mining enterprises shall be used to pay the income tax due for the period during which the investment is carried out. Any balance of credit shall be used to pay the income tax due for up to the 3 following periods.[31] The amount of the credit or balance thereof not used to pay the income tax of the period during which the investment is carried out is adjusted at the end of each period during which the value of the Peruvian currency against the American dollar changes by more than 5%.

The capitalization of the investments and reinvestments made by mining enterprises under rules discussed above is exempt from income and other taxes.[32]

c. *Permanency of taxation rules*

Mining enterprises commencing operations exceeding 350 but not 5,000 metric tons per day are given the guaranty that the taxation rules will not change for a period of 10 years as from the commencement of operations.

Mining enterprises already producing more than 350 but not more than 5,000 metric tons per day which increase their production capacity by 100% without exceeding 5,000 metric tons per day, are also assured the above privileged treatment for a period of 10 years as of the date on which the increase of production has been effected. If the growth is between 50 and 100%, the period of permanency is proportionally reduced.

Operations are deemed to be commenced or the increase effected once actual operations represent at least 80% of projected production, during 90 successive days.

The guaranty that the taxation rules will not change means that the taxpayer is subject to the tax regime in force on the date on which the program is approved and that no tax subsequently established shall be applied. This privileged tax treatment also covers assessment and payment rules but, in this case, the taxpayer can elect to be taxed under any new rules. Should any tax be replaced by a new one, the taxpayer shall pay the new tax up to the sum which would be due in the year under repealed rules. Anticipation of payments and compulsory loans in favor of the state are prevented by the scheme.

d. *Contracts with the government*

In order to promote investment and facilitate the financing of mining projects involving an initial production of at least 5,000 metric tons per day or increases of current production aimed at reaching the above level,[33] the Executive Branch is authorized to conclude, with the approval of the Council of Ministers, contracts with mining enterprises by means of which one or more of the following benefits may be granted:[34]

(1) the guaranty that the taxation rules in force on the date on which the contract was signed will remain applicable during 10 years;
(2) the authorization to use higher rates of depreciation allowances as regards machinery, equipment and other fixed assets, within the aggregate limit of 20% per year;
(3) the authorization to revalue the book of machinery and installations when the value of the Peruvian currency against that in which the investment was made undergoes a change which exceeds 5%.[35] The revaluation and subsequent capitalization of the appreciation are free from income and other taxes or duties;
(4) the reduction of the ordinary corporate income tax as calculated at rates in force on the date on which the contract is entered into, during the period which is necessary to recover the investment plus 3 additional years. The reduction that can be granted is limited to one third of the ordinary progressive rates.[36] This means that at least two thirds of the rates in force on the date on which the contract is concluded remain applicable;
(5) the authorization to keep accounting records in American dollars or in the currency in which the investment is made, provided the contract establishes that 80% of the production, or the additional production resulting from the contract, shall be exported. The system must be used for periods not shorter than 5 years and during such period the taxpayer is not allowed to revalue assets;
(6) the guaranty that the legal rules will remain applicable regarding the disposal of foreign currency de-

29. Under Decree-Law No. 22,401 the tax credit is normally calculated by applying the medium rate of income tax of the investment or reinvestment and by subsequently adjusting (in certain cases) the balance of that computation according to an "index of selectivity". This index varies for different activities and according to the priority level of the enterprise receiving the investment. As regards mining, however, the index is 1 and can therefore be disregarded.
30. Reinvestment programs must be submitted for approval during the taxable period or at least 60 days before the final income tax becomes due. The mining agency (Dirección de Fiscalización Minera) shall take the decision on the program within 45 days. If the decision is not taken or notice of the decision is not served within the 45-day term, the program is automatically approved. In order to enjoy the credit, enterprises must also file, within 60 days of the end of the corresponding period, a sworn return directed to a mining agency (Dirección de Fiscalización Minera) showing investments made in the period. In order to receive investments from third parties, it is necessary for an enterprise to have its programs approved by the government and use the funds received in discharge of the program within 3 years of the date of receipt.
31. Enterprises dealing with less than 5,000 metric tons per day can choose to take the credit under the aforesaid rules or under special rules.
32. Ordinary income taxation on capitalization is discussed in Sec. II. E.2.
33. Some other specified enlargements are also eligible for the scheme.
34. Incentives listed herein do not exclude the possibility for an enterprise to obtain the priviliged treatment as explained in Section III. B.2.c. above, provided the requirements discussed therein are met.
35. This possibility is not available for enterprises keeping their financial records in foreign currency.
36. For ordinary rates see Section II. E.1. above.

rived from the sale of products, as in force on the date in which the contract with the government is signed; and

(7) no discrimination as regards foreign exchange.

The above contract concluded between the government and mining enterprises shall be in force for the period which is necessary to recover the investment by using the gross income concept, less the income tax, the contribution to the Geological and Metallurgical Institute (Instituto Geológico Minero Metalúrgico) and profit shares payable to workers (participaciones liquidas y patrimoniales). For this purpose:

- "gross income" means the selling price minus costs. Depreciation allowances, amortization of invested capital, and investments or reinvestments for which tax incentives have been received are, in this case, not deductible as costs; and
- "investment" includes assets representing the acquisition of mining rights, the prospecting, exploration and development thereof, the purchase of machinery and equipment, winning plants, systems for power production, installations, earthworks, support facilities, housing and social welfare. Investments and reinvestments for which tax incentives have been received shall not be taken into account for the computation of investments to be recovered.

The contract may be revoked if the beneficiary does not provide assurances that the financing will be obtained within 18 months as of the date of its signature or if the work has not been commenced and finished within the time limit established in the contract, unless the delay is due to acts of God or force majeure.

e. *Special rules*

The general mining law includes special taxation rules for less developed areas, engineering ventures with foreign participation and small miners.[37]

Mining enterprises commencing their activities in the Jungle Region or in other areas of Peru which, due to geographic difficulties, have not benefitted from mining development receive the following additional incentives:

- for each ton of mineral ore or product that is sold, a tax credit certificate equal to 10% of the f.o.b. or ex factory value thereof with a minimum of 0.5% of a tax unit and a maximum of 1.5% of a tax unit. The certificate can be used for the payment of income and other taxes or transferred to other taxpayers for the same purpose; and
- concessionnaires for exploration can obtain an extension of their concessions for 5 additional years provided they meet certain requirements related to investments.

Engineering companies and professionals not domiciled in Peru rendering assistance services or preparing projects for mining, are wholly or partly exempt from income tax if they create, with Peruvian engineering companies or professionals, any kind of company or joint venture and contribute technology not available in the country. The activities of these enterprises must be performed in Peru unless it is necessary to carry them out abroad for sound reasons. The exemption is 100% if the Peruvian participation reaches at least 51% and is proportionally reduced if the Peruvian participation is less than 51%. The exemption applies to the income tax on dividends and profits belonging to the foreign company or professionals.

C. Other income specially taxed

The Peruvian income tax law provides special rules for the taxation of the following income-producing activities: communication, film distribution, imports and exports, insurance, news, oil-related services and transportation. Considering that these rules relate to international activities, a short description is given.

a. *Communication*

Income arising from communication services between Peru and foreign countries is considered to be Peruvian-source.

Where such income is derived by domiciliaries of Peru, it is presumed without right of rebuttal that its entire amount is Peruvian-source. This rule does not apply to branches or permanent establishments in Peru of foreign enterprises. Persons not domiciled in Peru and branches or agencies of foreign enterprises providing communication services in Peru are presumed, without right of rebuttal, to derive net Peruvian-source income equal to 5% of gross income from radiograms, telephone calls and similar communications made from Peru to another country.

b. *Film distribution*

Income arising from the leasing and other kind of exploitation of films, tapes, matrixes and other elements used for the projection or reproduction of images and sounds is considered to be Peruvian-source.

Where such income is derived by domiciliaries of Peru, it is presumed, without right of rebuttal, that its entire amount is Peruvian-source. This rule does not apply to branches or permanent establishments in Peru belonging to foreign enterprises.

Persons not domiciled in Peru and branches or agencies of foreign enterprises distributing cinematographic and similar films to be used by domiciliaries of Peru are presumed, without right of rebuttal, to derive net Peruvian-source income equal to 20% of gross receipts for the use of films for cinema or television, videotapes, soap operas, records, comics or any other similar means for projection, reproduction or broadcasting of images and sounds.

c. *Imports and exports*

Income arising from the export of goods produced, manufactured or purchased in Peru is considered to be Peruvian-source. For these purposes exports include remittances abroad made by subsidiaries, branches, representatives, purchasing agents and intermediaries acting for individuals and legal entities operating abroad.

For income tax purposes, the value of imports cannot ex-

37. Rules for small miners do not seem to offer special interest and are thus not discussed in this article.

ceed the ex factory value in the place from where they originate, plus expenses to the Peruvian port. Any excess amount shall be treated as taxable income of the importer, unless proof to the contrary is provided.

Likewise, for the same purposes, the value of exports cannot be less than the "real value", that is to say, its value in the consumer's market minus expenses. Any deficient sum shall be treated as taxable income of the exporter, unless proof to the contrary is provided.

d. *Insurance*

Income arising from insurance, reinsurance and back cessions is considered to be Peruvian-source.

Where such income is derived by domiciliaries of Peru, it is presumed, without right of rebuttal that its entire amount is Peruvian-source. This rule does not apply to branches or permanent establishments in Peru belonging to foreign enterprises.

Non-domiciliaries insuring risks in Peru are presumed, without right of rebuttal, to derive Peruvian-source income equal to 7% of:
- net premiums (exclusive of commissions paid in Peru) remitted by enterprises organized and domiciled in Peru; and
- income (net of commissions) received for reinsurance covering risks located in Peru, or referring to residents thereof or to property located therein.

e. *News*

Income arising from the supply of news by international agencies is considered to be Peruvian-source.

Where such income is derived by domiciliaries of Peru, it is presumed, without right of rebuttal, that its entire amount is Peruvian-source. This rule does not apply to branches or permanent establishments in Peru belonging to foreign enterprises.

International news agencies are presumed, without right of rebuttal, to derive net Peruvian-source income equal to 10% of gross remuneration received for the provision of news and, in general, information and material for printing to persons or entities that are domiciled in Peru or use the material therein.

f. *Oil-related services*

Contractors and subcontractors not domiciled in Peru, rendering specific services related to the exploration, drilling, development and transportation of oil, are presumed, without right of rebuttal, to derive net Peruvian-source income equal to 25% of gross receipts.

Contractors and subcontractors domiciled in Peru, rendering the same services, are presumed to derive a minimum taxable income equal to 15% of gross receipts.

g. *Transportation*

Income arising from transportation between Peru and foreign countries is considered to be Peruvian-source.

Where such income is derived by domiciliaries of Peru, it is presumed, without right of rebuttal that its entire amount is Peruvian-source. This rule does not apply to branches or permanent establishments in Peru belonging to foreign enterprises.

Persons not domiciled in Peru and branches or agencies of foreign enterprises rendering transportation services in Peru are presumed, without right of rebuttal, to derive net Peruvian-source income equal to 1% of gross income from transportation by air and 2% of gross income from transportation by sea.

Persons not domiciled in Peru leasing airplanes are presumed, without right of rebuttal, to derive net Peruvian-source income equal to 60% of gross receipts arising from such leasing.

Income from the leasing of boats and airplanes is taxed at a 10% rate.

D. Taxation of investment income

1. Taxation of capital gains

Capital gains from the transfer of property are taxed only when derived from *habitual* transactions[38] or if they arise from the transfer of the following items:
- immovalbe property, provided the transferor has made in the taxable period or in the 2 preceding periods at least 2 purchases and 2 sales of immovable property;
- shares, provided the transferor has made in the same period at least 10 purchases and 10 sales;
- immovable property previously acquired with the purpose of being subsequently transferred or which is sold within a development or subdivision scheme;
- property received as a payment for habitual transactions;
- personal property which may be depreciated;
- goodwill, trademarks and similar items;
- property belonging to legal entities or enterprises organized abroad and performing in Peru activities that produce third category income;
- business or enterprises; or
- rights or concessions.

2. Taxation of dividends paid to domiciliaries

Dividends paid to legal entities are not computed in calculating the aggregate income of the recipient. However, dividends paid to legal entities are subject to a 25% withholding tax which is creditable against the same tax due on subsequent distributions.[39] Dividends paid by legal entities domiciled in Peru out of exempt dividends or interest received from other companies are not taxable, provided the redistribution is carried out within the 2 periods following the one during which they were received.[40]

38. It is presumed that transactions are not habitual if they refer to:
- immovable property acquired gratuitously by inheritance;
- immovable property which has been used by the vendor for dwelling purposes for at least 1 year;
- immovable property owned for at least 2 years;
- shares and participations acquired gratuitously by inheritance; and
- shares and participations owned for at least 2 years.

39. The tax, however, cannot be refunded.

40. For allocation purposes, distributions are deemed to be first paid out of exempt dividends or interest and subsequently out of other income.

In order to benefit from the credit or exemption referred to, it is necessary that the following conditions be met:

- if the redistribution is made in shares, it must be made in the same shares as previously received. However, the company making the redistribution may capitalize the shares received from another company and make the redistribution in its own shares;
- if the redistribution is made in cash it must be paid out of cash dividends; and
- if the redistribution is made in kind it must be made with the same items received from another company.

Dividends paid to resident individuals are subject to a 25% withholding tax representing a prepayment which is creditable against the final liability to the income tax. Dividends paid on shares distributed to workers under the scheme of workers' participation in profits[41] are subject to income tax under the same rules applicable to salaries, as long as the employment condition exists. After retirement, however, they are taxed as ordinary dividends.

Stock dividends can be subject to the same regime of dividends unless the capitalization tax or other rules discussed in Section II. E. 2. apply.

The concept of dividend includes:

- income distributed to shareholders by corporations and partnerships limited by shares whether in cash, kind or shares of the distribution company;
- distributions of shares representing a revaluation of fixed assets which is in excess of the amount authorized by the law;
- sums received upon the liquidation of a company which are in excess of the normal value of shares and certain specified premiums;
- shares in profits;
- any loan or delivery of goods to shareholders not exceeding profits and free reserves which is not refunded within 12 months; this standard is not applicable to banks and financial institutions; and
- any sum which, upon a tax audit is assessed as third category income, provided the payment thereof represents an indirect disposal of income which has escaped taxation. In this case the tax discussed in Section II.E.2.b. is due.

On the other hand, the term "dividend" does not include:

- certain specified premiums;
- shares of the distributing company representing the capitalization of revaluations authorized by law. If the shares are distributed to legal entities, the shares must be registered by the recipient in a special reserve account to be used for offsetting losses and distributed only upon the sale of the shares for which they were received.

3. Taxation of interest paid to domiciliaries

Interest paid to domiciliaries is taxed as ordinary income of resident individuals and corporations. However, a final 40% withholding tax is levied on interest paid on bearer bonds and securities.

For the purposes of income taxation, it is presumed, without right of rebuttal, that any loan produces at least the interest charged by the Central Bank on rediscount to commercial banks. This assumption is not applicable in specified instances including loans granted by non-domiciliaries from abroad. Moreover any sum refunded by the debtor which exceeds amounts received is presumed to be interest.

The law provides for the following exemptions:

- interest on loans granted by the Peruvian government or agencies thereof (sector público nacional); and
- interest on savings deposits and contributions.[42]

4. Taxation of royalties paid to domiciliaries

Royalties paid to a Peruvian individual or corporation are considered to be business profits and treated as ordinary income.

The term "royalty" is deemed to include any consideration in cash or in kind paid for the use of or the right to use any patent, trademark, design or model, plan, secret formula or process, and copyrights of literary, artistic, or scientific work, as well as for information concerning industrial, commercial or scientific experience.

Recipients of royalties may deduct 10% of such income during the period necessary to recover expenses incurred in Peru for the acquisition, production and registration of the assets for which the royalties are paid.

E. Taxation of income derived by non-domiciliaries

1. General rules for the taxation of non-domiciliaries

Income of any kind paid or credited to beneficiaries not domiciled in Peru is subject to final withholding tax at the following rates:

- dividends: 30%;
- interest: 40%, 10% or exempt;[43]
- royalties: 25%;
- income from the leasing of boats or airplanes: 10%;
- after tax profits of branches or agencies belonging to nonresidents: 30%;
- pensions or remuneration for personal services rendered in Peru: progressive rates used for resident individuals which range from 2 to 65%; and
- non-specified income: 40%.

The withholding tax is calculated on the following amounts which, for this purpose, are deemed, without right of rebuttal, to be net income:

(1) for first category income (i.e. income from real property), the tax is levied on the net or taxable income established under special rules provided by the law;

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41. The scheme for workers' participation in profits is discussed in the Introduction to the Peruvian chapter in Section C of *Corporate taxation in Latin America* (International Bureau of Fiscal Documentation, Amsterdam).

42. There are also some items which are exempt in accordance with legislation existing prior to the enactment of the current income tax law and which has not been revoked by the new legislation, i.e.:

- interest on bank certificates in foreign currency and deposits in foreign currency with financial enterprises (Decree-Laws No. 22,038 and 22,891);
- interest on securities issued by the government agency for development "Cofide" (Decree-Laws No. 21,020 and 22,891); and
- interest on bonds issued by financial enterprises and fixed term deposits (Decree-Laws No. 18,957, 20,114 and 22,891).

43. For further discussion, see Section III. E.4. below.

(2) for royalties, the tax is levied on gross receipts minus deductions (discussed in Section III. E.5. below);
(3) for life pensions, the tax is levied on gross receipts minus a deduction equal to 50% thereof, made to recover the investment and limited, in the aggregate, thereto;
(4) for other non-specified second category income (e.g. dividends and interest), the tax is levied on the total of the income paid or credited to the non-domiciliary;
(5) for income specially taxed (i.e. derived from communication, film distribution, imports and exports, insurance, news, oil-related services and transportation), the tax is levied on the corresponding amount established under the rules discussed in Section III. C. above;
(6) for other non-specified third category income (i.e. business income),[44] the tax is levied on the amount paid or credited to the non-domiciliary;
(7) for fourth category income (i.e. income from professional services), the tax is levied on 90% of sums paid or credited to the non-domiciliary.
(8) for fifth category income (i.e. income from employment), the tax is levied on 100% of sums paid or credited to the non-domiciliary; and
(9) for income not listed above, originating from the transfer of goods or rights or from the exploitation of goods subject to wear and tear, the tax is levied on receipts minus invested sums (costs).

For withholding tax purposes, income derived from business associations not considered to be legal entities for income tax purposes shall be deemed to be paid or credited to the beneficiary abroad as from the date on which the annual income tax returns are due.

2. Taxation of income derived through branches

Profits derived by branches or agencies established in Peru are taxed in accordance with ordinary rates (see Section II. E.1.), and, in addition, the after tax profits that are available to the principal abroad are subject to a 30% withholding tax.

Expenses incurred by a branch, which represent taxable income for other branches or agencies, are deductible, provided the payment can be duly controlled and does not constitute indirect distribution of profits.

3. Taxation of dividends paid to non-domiciliaries

Dividends paid to beneficiaries not domiciled in Peru are subject to a 30% withholding tax which is final.

For the concept of dividend see Section III. D.2. above.

4. Taxation of interest paid to non-domiciliaries

Interest paid to non-domiciliaries can be subject to 3 different tax regimes:

- the interest is subject to a 40% final withholding tax if no other specific rule is provided for;
- the interest is subject to a 10% final withholding tax, if it is paid to legal entities on loans or financing specified by the law and discussed below; or
- the interest is exempt from income taxation in instances discussed below.

The instances where interest paid to legal entities is subject to 10% tax are the following:

- interest on foreign financing, provided:
  - the proceeds of the financing are sold in the Single Exchange Market (this requirement applies to cash loans only);
  - the annual interest (inclusive of commissions, premiums and any other charges) does not exceed by more than 3 points the prime rate of the financial market from which the monies come; and
- interest paid abroad by banks and financial enterprises established in Peru for the use of their credit lines abroad.

The following interest is exempt from income tax:[45]

- interest on development loans granted by international organizations or by institutions belonging to foreign governments;
- interest on loans granted by foreign institutions for the construction, acquisition, installation or operational start of new fixed assets, or for working capital which is necessary for the establishment or development of the enterprise, provided some additional requirements are met; and
- interest on saving deposits and contributions.

5. Taxation of royalties paid to non-domiciliaries

Royalties paid to beneficiaries not domiciled in Peru are subject to a 25% withholding tax, which is final.[46]

Any recipient of royalties may deduct 10% of such income during the period necessary to recoup expenses incurred in Peru for the acquisition, production and registration of the assets for which the royalties are paid.

Non-domiciliary recipients of royalty payment habitually performing research and experimentation in order to find the kind of assets for which the royalties are paid can deduct the corresponding expenses, up to 5% of gross royalties. The government may, for specific cases, change the limit.

In case of technical services requiring activities which are partially performed in Peru and partially performed abroad, net income is presumed to be 40% of gross receipts.

Royalties paid for technical, economic, financial or any other assistance rendered from abroad by governmental agencies or international organizations are exempt from income taxation.

IV. SALES TAXATION

A. The general tax on sales

1. General description

The Peruvian legislation in force before the 1981 reform included a sales tax (Impuesto a los Bienes y Servicios) which covered goods and services. For goods it was a value-added tax levied at the producer and wholesale

44. Not referred to in (5) above or in (9) below.
45. For more exemptions, see footnote 42.
46. For the concept of royalty, see Section III. D.4. above.

levels. However, no credit was granted for the acquisition of fixed assets and services.

Legislative Decree No. 190 included in the reform package introduced a new general tax on sales (Impuesto general a las ventas) which extends the coverage of sales taxation to the retail level, taxes some services previously exempt and grants credits for fixed assets and services. The change entered into force on 1 November 1981.

2. Taxable persons

The general tax on sales is levied on individuals and legal entities that:
- perform sales of taxable goods, irrespective of the stage of the production and distribution process at which their activity is carried out;
- import goods; or
- render specified services listed in Appendix II to the law.

3. Taxable transactions

The general tax on sales is levied on the following transactions:
- the sale of movable goods carried out in Peru;
- the rendering of specified services listed in Appendix II to the law; and
- the importation of goods. Exports of goods are not subject to the tax.[47]

For the purpose of the tax, a "sale" is any transaction by means of which goods are transferred for a consideration. Taxable sales also include:
- any disposal of goods made by an enterprise, its owner or partner, for purposes other than business activities; and
- any disposal of goods not allowed as an expense for income tax purposes.

A "sale", however, does not include the transfer of inventory under a merger transaction or at the alienation of an enterprise.

For purposes of the tax, "movable goods" are those goods that can be moved from one place to another, rights thereon, boats and airplanes.

The services subject to the tax are listed in Appendix II to the law and include the following items:
- lodging services, sale of food and drink carried out in lodging establishments, tourism facilities, restaurants, bars, night clubs, clubs and any similar establishment;
- services rendered by general warehouses (almacenes generales de depósito);
- data processing, tabulation and electronic computation;
- advertising, publicity and similar services;
- cleaning of buildings, chimneys, windows and similar services;
- radio and television broadcasting (inclusive of closed circuit television services);
- repair, maintenance, reconstruction and alternation of movable property;
- laundry and dyeing services;
- services of hair dressers, beauty parlors, saunas, masseurs and the like;
- furniture decoration;
- photographic services;
- photocopies, copies, reductions and similar services; and
- leasing and subleasing of movable property.

Financial leasing is also taxed. However, the leasing and subleasing of agricultural machinery are exempt.

Exempt items are listed in Appendix I to the law which is in force up to 31 December 1990. The list includes: living animals, meat, fish, milk, butter, eggs, honey, plants, flowers, vegetables, fruit, coffee, cereals, flour, seeds, edible oil, sugar, cacao, pasta, bread, food for animals, unprocessed tobacco, salt, sulfur, graphite, sand, plaster, medicines, fertilizers, pesticides, India rubber, rubber, hides, wood, cork, copybooks, books, newspapers, periodicals, wool, cotton, hemp, machinery for agriculture, etc.

Exemptions cover the sale of used property carried out by individuals or legal entities not performing business activities. Future exemptions not listed in Appendix I to the law must be granted specifically and be included therein. General exemptions[48] already granted or to be granted in the future shall not be deemed to include the general tax on sales. However, imports previously exempt from the old tax on goods and services are automatically exempt from the new general tax on sales.

4. Taxable amount

The tax is calculated by applying the rate, as the case may be, to:
- the value of sales;
- the full amount of receipts from services; or
- the c.i.f. customs value of imports, as increased by duties and taxes on imports but exclusive of the general tax on sales.

The "value of sales" or the "receipts from services" include the full amount to be paid by the acquirer of goods or user of services. This amount comprises the full value of invoiced goods or services, inclusive of sums charged separately even if originating from complementary services, interest, financing expenses or any expense incurred on account of the purchaser or user of services.

Also included in the value of sales or the receipts from services are the excise tax (Impuesto Selectivo al Consumo) and any other taxes on production, sales or services. However, as regards the sale of gasoline and fuels

47. The liability to the tax arises:
- as regards the sale of goods, either on the date on which the invoice is issued or on the date on which the good is delivered, whichever is first;
- as regards the sale of boats and airplanes, on the date on which the contract is signed;
- as regards the disposal of goods for purposes other than business activities, on the date of the disposal;
- as regards the rendering of services, either on the date on which the invoice or receipt of payment is issued or on the date on which the consideration is received (whichever is first); and
- as regards the importation of goods, on the date on which customs clearance is applied for.

48. I.e. exemptions which do not specifically mention the general tax on sales.

derived from petroleum, the tax on vehicles (Impuesto de Rodaje) is not included in the value of sales for the computation of the general tax on sales. Likewise discounts and bonuses shown in invoices are not included in the taxable amount, provided they are in accordance with normal trade practices.

The price of assembly or installation "in situ" of pre-fabricated parts, performed by the vendor of such parts,is to be included in the value of sales. This provision covers pre-fabricated parts of bridges, watertanks, depots and stores, railways, highways, lifts, mechanical ladders, plumbing, sprays for fire prevention, central heating, ventilation, air conditioning, lighting, electric circuits, similar facilities in buildings and any structures.

5. Computation of the tax

The general tax on sales is essentially a value-added tax. This means that the tax rate provided by the law is applied to taxable amounts and the tax liability resulting from that calculation is reduced, where appropriate, by crediting against this liability the tax on goods or services supplied to the taxpayer.

The Peruvian sales tax law provides for a single 16% rate. Nevertheless, industrial enterprises established in less developed areas receive tax reductions. In addition, enterprises established in the Jungle Region benefit from even more substantial reductions and exemptions. These special regimes shall be further discussed in Section IV. A.6. below.

The tax credit is granted for purposes of the general tax on sales if it is registered separately in invoices substantiating the acquisition of goods and services and also for this tax paid on imports.

In order to enjoy a credit on the acquisition of goods and services:
- the acquisition price must be deductible as an expense or cost under the income tax legislation;
- the goods and services must be used to perform transactions subject to the general tax on sales or on "non-traditional exports";
- the tax must be registered separately in the invoice substantiating the acquisition of a taxable good or service or in the import documents;
- the invoice must be issued in the way established in regulations to the law; and
- the invoice or importation document must be registered in the taxpayer's record of purchases.

The credit originating from the acquisition of goods subject to depreciation (fixed assets) must be divided in 4 annual installments and taken as from the calendar year during which the use of such goods commences. If an asset is sold before the 4-year term has elapsed, any unused balance of the credit can be offset only against the tax arising from the sale of the asset itself. However, if the enterprise has not commenced operations, the credit arising from the acquisition of fixed assets may be refunded, provided the asset has not been put into use.

Where a taxpayer simultaneously performs taxable and non-taxable transactions, certain provisions established in regulations to the law must be taken into account for the computation of the credit.[49]

When an enterprise is reorganized or transferred, the existing tax credits thereof can be transferred to the new or acquiring enterprise. However, if an enterprise is liquidated, the credit is not refunded.

6. Special rules

a. *Less developed areas*

Industrial enterprises of the first, second and third priority[50] established or to be established in less developed areas[51] pay the general tax on sales under more favorable rules.

The "less developed areas" entitled to the tax reduction include any area of Peru other than the provinces of Lima, Cañete, Chancay and Huaral of the Department of Lima, and Callao.

The special rules provide for a tax reduction which is calculated under the following provisions:
- the tax debit of the month (i.e. the tax liability arising from goods and services sold in the month) is reduced by 15% of its amount;
  for enterprises that are established in less developed areas on or after 1 January 1980, the reduction for the first 5 years as from commencement of operations is 40%;
  for enterprises that were already established in less developed areas before 1 January 1980, the reduction for that part of the 5-year period (computed as from commencement of operations) which was still available when Legislative Decree No. 190 entered into force (i.e. on 1 November 1981) is 30%; and
- the tax credit is calculated on purchases and services received under ordinary rules and is not limited or affected by the reduction of the debit.

Thus, by reducing the debit and maintaining the credit untouched, a reduction is produced in the final tax.

b. *Jungle Region*

Taxpayers domiciled in the Jungle Region enjoy a more favorable regime as regards the general tax on sales, even if compared with less developed areas in general.

The Jungle Region encompasses the departments of Loreto, Ucayali, San Martin, Amazonas, and Madre de Dios.

To be eligible for the benefits a person must:
(1) be domiciled in the Jungle Region; and
(2) perform 75% of his transactions in the Jungle Region.

Legal entities must in addition:
(3) be organized and registered in the Jungle Region; and
(4) have their management in the Jungle Region.

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49. Article 31 of Supreme Decree 245-81-EFC of 4 November 1981.
50. Under the General Industrial Law (Decree-Law No. 18,350 of 27 July 1970, as amended) industrial activities are classified in 4 priority groups. For further discussion, see Industrial Incentives in Section 6.02 of the Peruvian chapter in Section C of *Corporate Taxation in Latin America*.
51. For incentive purposes it is necessary to separate ordinary "less developed areas" from some less developed areas which enjoy an even more privileged regime, e.g. the Jungle Region which is discussed in Section IV. A.6.b.

Commercial enterprises belonging to the government or to its agencies only need comply with requirements (3) and (4).

The benefits available for the Jungle Region are the following:

(1) the importation of goods specified in an Appendix to Decree-Law No. 21,503, to be consumed in the Jungle Region, and imports of raw materials for the production of such goods are exempt from the general tax on sales. This exemption does not apply to goods similar to those already produced in the region in an amount sufficient to cover the needs thereof;

(2) the sale of the goods specified in an Appendix to Decree-Law No. 21,503 to be consumed in the Jungle Region and the sale of raw materials for the production of such goods are exempt from the general tax on sales;

(3) sales and services subject to the general tax on sales (i.e. sales and services which are not exempt under the rules discussed in (1) and (2) above) may receive the tax reductions granted to the enterprises established in less developed areas;

(4) merchants established in the Jungle Region that purchase, from taxpayers established outside the region, the goods specified in an Appendix to Decree-Law No. 21,503, to be consumed in the Jungle Region, may receive a refund of the general tax on sales invoiced for the purchase. If the purchase is made from a producer receiving the benefits granted to enterprises established in less developed areas, the refund is limited to 60% of taxes invoiced. This refund does not cover the purchase of goods similar to those already produced in the region in an amount sufficient to cover the needs thereof; and

(5) manufacturers established in the Jungle Region producing the goods specified in an Appendix to Decree-Law No. 21,503, to be consumed in the Jungle Region, may receive a refund of the general tax on sales invoiced for the purchase from other areas of Peru of raw materials to be used in such production. If the purchase is made from a producer receiving the benefits granted to enterprises established in less developed areas, the refund is limited to 60% of invoiced taxes.

7. Tax administration

a. *Tax returns, payments and refunds*

The tax arising from sales and services must be calculated monthly and paid in to authorized banks within the first 15 days of the month following that during which transactions are carried out. The tax arising from imports is calculated by the customs service and must be paid together with custom duties.

If no liability to the tax arises in a particular month, the taxpayer must notify the tax administration. Where credits arising in a month exceed liabilities, the balance is carried forward to subsequent months.[52]

A refund may be obtained as regards:

- credits belonging to enterprises that have not commenced operations, provided the credits arise from the acquisition of fixed assets that have not yet been used; and
- credits corresponding to exports[53] to which persons are entitled who do not perform transactions subject to tax (or who perform them to an extent which is not sufficient to absorb the credits within 3 months). Under the same circumstances credits to which exporters are entitled can be used to satisfy some specified taxes (e.g. income tax prepayments).

Taxpayers subject to the general tax on sales must additionally file annual returns showing their acquisitions of the year, whether taxable or exempt.

b. *Tax audits and control*

The tax administration is vested with the power to estimate the value of goods and services, if the value is not specified or if the value indicated by the parties does not seem to be reliable.

If the tax on monthly sales has not been paid and if no notice on the absence of liability to the tax been given,[54] the tax administration may require that the taxpayer comply with his duty within 10 days.

If after the 10 days' term the taxpayer has not complied the tax administration may charge and compulsorily collect, without further delay, a sum established on the basis of the tax paid in previous periods, increased by surcharges and interest. If the tax administration makes use of this authority, the taxpayer's rights will be limited to refund claims based on excessive collection. The steps taken by the tax administration do not preclude its power to assess any tax actually due on the basis of other elements.

Where the taxpayer omits to prepare and deliver invoices or the registration thereof or where the tax administration has sound reasons to believe that the taxpayer's notices, self-assessments and returns are not correct, the tax administration may assess the tax on the basis of differences in inventories, averages of estimated sales, market values, and other data specified in regulations to the law.

The tax administration may assume, unless proof to the contrary is provided, that differences in inventories between those registered in the taxpayer's books and those accounted by the tax administration correspond to unreported sales of the last preceding year. The amount of unreported sales is then calculated by applying to the difference in inventory established by the tax administration the same rate that taxable sales of the last preceding year bear to the closing inventory of the same year.

The unreported sales computed as aforesaid are allocated to the different months of the year proportionally to reported sales of each month and the tax is then calculated without considering the credits that may exist. At the same time, unreported sales are deemed, without right of rebuttal, to be net income and subject to the income tax.

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52. For credits arising from the acquisition of fixed assets, see Section IV. A.5. above.
53. Note that credits corresponding to exports are available only as regards non traditional exports.
54. See Section IV. A.7.a. above.

The tax administration may also assume, unless proof to the contrary is provided, that sales in a particular month are equal to a daily average of sales which is multiplied by the working days of the month.

The daily average is established on the basis of sales made by the taxpayer under the control of the tax administration during 5 consecutive or alternative days in the month. If the 5 days' control is carried out in at least 4 alternate months of the same calendar year, the average of monthly sales and services established as aforesaid can be used to calculate the sales of the non-controlled months of the year. The difference in sales between those reported by the taxpayer and those estimated under the preceding rules is also treated as net income and subject to the income tax.

Furthermore, the same percentage that unreported sales of the last year, as established under the preceding rules, bear to reported sales of the same year can be used to assess unreported sales of the preceding year, provided the tax administration can prove that accounting records do not correspond to actual transactions.

c. *Small taxpayers*

Small taxpayers, i.e. taxpayers with annual sales not above 200 tax units, can choose to be taxed under a simplified system. Under this system the liability to the General Tax on Sales (tax debit) equals a certain percentage (which cannot exceed 16%) of an amount of sales equalling 200 tax units.

Under the scheme, the taxpayer is permitted to credit against his liability the tax paid on acquisitions of the period, but, if credits exceed debits, no refund is granted.

Individuals whose annual sales are not above 35 tax units are not subject to the general tax on sales. This exemption does not cover importers.

B. The excise tax

1. General description

The Peruvian legislation existing to the 1981 tax reform included several separate excise taxes.

Legislative Decree No. 190 introduced a new excise which is in force as from 1 November 1981 and replaces the separate taxes previously levied on tobacco, manufactures thereof, non-alcoholic beverages, beauty products, coca, petroleum derivatives, alcohol, alcoholic beverages, cars and tourism services.

The new excise tax is levied at production level on specified goods and services at rates up to 116% (for Virgina-type cigarettes).

2. Taxable persons

The excise tax is levied on:
- producers and economically connected enterprises, as regards sales carried out in Peru;
- importers of goods subject to the excise tax; and
- persons rendering services subject to the excise tax.

For the purposes of the excise tax, "producer" means any person taking part in the last stage of the process by means of which goods receive the condition of a product subject to the tax, even if the activity is performed by using the services of a third party.

For the same taxation purposes, enterprises are deemed to be economically connected if:
- one of the enterprises owns more than 30% of the capital of another enterprise, either directly or through a third enterprise;
- more than 30% of the capital of 2 or more enterprises belongs to the same person, either directly or indirectly;
- more than 30% of the capital of 2 or more enterprises belongs to a married couple, or to persons who are close relatives, as specified in the law.

If an item is sold by the producer to an economically connected enterprise, both this sale and the sale made subsequently by the connected enterprise are subject to the excise tax, unless the following conditions are met:
- proof is submitted that the price of the first sale is not below the price charged for the same items by the producer to unconnected enterprises; and
- sales to unconnected enterprises are not below 50% of the sales made by the producer in the period.

When the subsequent sale by the connected enterprise is subject to the excise tax, then the tax paid upon the purchase from the producer is creditable against the liability for the subsequent sale.

3. Taxable transactions

The excise tax is levied on:
- sales of specified products carried out in Peru at producer level;
- importation of the same specified products; and
- the rendering of specified services.

For the purposes of the excise tax, the term "sales" has the same meaning it has for the purposes of the general tax on sales. Likewise, the liability to the excise tax arises under the same rules as provided for the general tax on sales.

The specified items on which the tax is levied are listed in Appendices III and IV to the law.[55]

4. Taxable amount

The excise tax is calculated by applying the corresponding rate, as the case may be, to:
- the value of taxable sales;
- the full amount of receipts from taxable services; or
- the c.i.f. customs value of imports as increased with customs duties.

The rules used to determine the taxable amount for the purposes of the general tax on sales are also applicable to the excise tax. The general tax on sales and the excise tax, however, are excluded from the taxable amount. For gasoline and fuels derived from petroleum, the taxable amount is the ex factory price exclusive of the general tax on sales and the circulation tax. (Impuesto de Rodaje).

For imported cigarettes, the c.i.f. customs value cannot be less than 0.03% of a tax unit per pack or 20 units.

55. See footnote 56 below.

5. Tax rates

The rates of the excise tax are specified in Appendices III, IV and V to the law. The principal rates for sales are: 10, 20, 25, 30 and 40%. The rate for services is 10%.[56]

C. Special tax

The exports of traditional products are subject to a "special tax" payable by exporters and by state-owned commercial enterprises that export on account of third parties.

The tax is calculated on the f.o.b. value of exports at a 3% rate. For products listed in Appendix VI to the law the rate is 2%. Some of the products included in the list are: common salt, natural graphite, natural sands, quartz, clay, chalk, calcium phosphate, pumice-stones, emery, marble, chip slate and other construction stone, magnesia, plaster, asbesto and borates.

V. FINAL REMARKS

Although this article was not intended to and does not cover the new legislation in its entirety, it easily conveys an idea of the broad coverage thereof. The recent Peruvian tax reform includes, in fact, new statutes for all the principal taxes.

An attempt was made in this report to show what seemed to be the principal aspects of the new legislation. It may now be useful to summarize those features that are most relevant and interesting:

(1) the change-over from the principle of world-wide taxation of income derived by residents or domiciliaries of Peru to the limited taxation of the Peruvian-source income. With this change Peru follows the views held on the subject by the prevailing Latin American doctrine;

(2) the design of the progressive income tax tables for individuals and corporations with brackets expressed in tax units, which amounts to an automatic adjustment of those brackets for inflation;

(3) the reorganization of sales taxation, including:
  - the reinforcement of the value-added nature of the general sales tax by covering the retail stage and a number of services previously exempt and by granting credits for fixed assets and services; and
  - the consolidation of most excise taxes (which are now included in a single law) following the views of LAFTA experts and the example of other Latin American countries (e.g. Brazil, Chile and Mexico);

(4) the provision for rules on the reorganization of companies, covering both the income tax and sales taxes, in an area where, with very few exceptions, this kind of rule is lacking;

(5) the rules on less developed areas which together with other tax benefits previously in force represent an incentive scheme the growth and importance of which reminds one of the Brazilian scheme;

(6) the new mining legislation reflecting the importance of this activity for the Peruvian economy and including important tax incentives;

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56. A 10% rate applies to: color television sets, specified cars and cameras. The Executive Branch can include new items in the list of products subject to the 10% rate, provided there is an increase in the customs duties on these products.
A 20% rate applies to: firework articles, carpets, rugs, wigs, porcelain and ceramic figures, decorative crystal objects, imitations of fine pearls, and imitations of precious and semi-precious stones, domestic freezers, domestic washing machines for dishes, domestic dryers, grinders, mixers and fans, musical boxes, appliances for the recording and reproduction of sounds, appliances for the recording and reproduction of images and sounds for television, musical boxes and similar items, tapes, videotapes, lighters, pipes, cigar-holders, and toilet sprays.
A 25% rate applies to: mineral and effervescent water, beer, wine, vermouths, cider, cognac, brandy, grappa, pisco, perfumes, beauty products and furs.
A 30% rate applies to: caviar, rum, liquor, similar beverages, fine pearls, diamonds, precious stones, semi-precious stones, artificial stones, articles made of gold, fine pearls, precious stones, semi-precious stones or artificial stones, glasses made of precious metals or covered therewith, watches made of precious metals or covered therewith, worked ivory, mechanical, electrical and electronic toys, pens, pencils and lighters made of precious metals or covered therewith.
A 40% rate applies to: specified cars, yachts, and pleasure boats.
Different rates apply to the following products:

- black tobacco cigarettes — 56%
- Virginia-type cigarettes — 116%
- gasoline for motors
  - coast and highlands — 60%
  - jungle — 14%
- kerosene for domestic use
  - coast and highlands — 13%
  - jungle — 14%
- kerosene for industrial use
  - coast and highlands — 34%
  - large mining enterprises — 39%
  - jungle — 22%
- gasoil (diesel 1)
  - coast, highlands and great mining — 43%
- gasoil (diesel 2)
  - coast, highlands and great mining — 46%
  - jungle — 22%
- fuel oil (petroleum residual 5)
  - coast, highlands and great mining — 46%
- fuel oil (petroleum residual 6)
  - coast, highlands and greatmining — 56%
  - jungle — 22%
- liquified petroleum gas — 13%

Different rates apply to the follwing services:

- commissions and interest received by banks, financial and credit institutions. — 17%
  (exemption is granted to the Agrarian Bank of Peru, interbank transactions, commissions and interest derived from direct cash loans);
- insurance premiums, interest and commissions received by insurance companies — 10%
  (for reinsurance the tax is levied on the receipts belonging to each company. Exemption is granted to insurance covering transportation of products marketed by the Government, insurance covering export financing, premiums and commissions for reinsurance received or transferred in the Peruvian market);
- international tickets for passenger transportation — 14%
  (exemption is granted to diplomatic and consular personnel and members of international organizations discharging their duties in Peru);
- cable, telex and long distance telephone services; — 15%
- local telephone services; — 10%
- leasing and distribution of films; — 10%
- leasing and subleasing of immovable property — 5%
  (exemption is granted for the leasing and subleasing of dwelling houses the rent of which is limited under Decree-Law No. 21,938).

(7) the control powers vested in the tax administration, especially as regards the broad possibilities to presume or estimate the amount of taxable income and sales. These powers can represent an important tool for the enforcement of the tax law in countries where control is difficult due to the number of taxpayers, the poor development of business organization and low compliance; they must, however, be wisely managed because the risk of unfair use seems to be inherent in the nature thereof; and
(8) the restriction imposed on the audit and assessment powers of the tax administration for the case in which the taxpayer's last return is not objected to. This permanent provision is a Latin American novelty and represents a very special encouragement to compliance.

In accordance with information received after this article had been prepared, Law No. 23,337 of 14 December 1981 introduced amendments to some of the subjects discussed here. For further information on such amendments the reader is referred to a note to be published in forthcoming issues of the *Bulletin* and *Tax News Service*.

CHINA – U.S.A.

Agreement with respect to the mutual exemption from taxation of income derived by air and shipping transport enterprises signed

On 5 March 1982, the Chinese Minister of Finance, Mr. Wang Bingqian, and the Ambassador of the U.S.A. to China, Mr. Arthur W. Hummel, signed an agreement that exempts air and shipping transport enterprises of one state from taxation of income in the other state.

Although this is not the first agreement of this nature to which China is a party, the Editors of the *Bulletin* nevertheless find that this very agreement is of particular interest to the world of taxation since it was concluded after implementation of major tax reforms in the People's Republic of China.

It should be noted that China has not yet concluded any comprehensive treaty for the avoidance of double taxation but it is understood that negotiations in this field are going on with a number of countries.

Note: The Bureau has published a comprehensive description of the Chinese tax system in its loose-leaf work *Taxes and Investment in Asia and the Pacific* (also available as an offprint: *Investment and Taxation in the People's Republic of China,* 3rd edition; the 4th edition will be available in the near future).

The government of the United States of America and the government of the People's Republic of China have agreed as follows, with respect to mutual exemption from taxation of transportation income of shipping and air transport enterprises:

Article I

Income and profits of an enterprise of a contracting state from the operation of ships or aircraft in international traffic shall be taxable only in that contracting state.

Article II

1. The term income and profits from the operation of ships and aircraft includes:
(A) Income and profits from the operation of passenger, cargo, or mail transportation service by the owner or charterer of a ship or aircraft, and the sale of tickets related to such transporation;
(B) Income and profits from the rental of ships or aircraft which are operated in international traffic by the lessee;
(C) Income and profits from the rental of ships or aircraft if such rental is incidental to the operation of ships or aircraft in international traffic; and
(D) Income and profits from the rental or use of containers (and related equipment for the transport of containers) used in international traffic.
The income and profits referred to in (A) through (D) above are, in such case, derived by an enterprise of a contracting state.
2. The term international traffic means any transport by a ship or aircraft, except when such transport is soley between places in the other contracting state.

Article III

Gains derived by an enterprise of a contracting state from the alienation of ships, aircraft, or containers operated in international traffic shall be taxable only in that state.

Article IV

1. The term enterprise means:
(A) A state-owned or collectively-owned enterprise of, and an enterpriser carried on by a resident of, the People's Republic of China; and
(B) An enterprise carried on by a company incorporated in the United States of America and an enterprise carried on by a resident of the United States of America.
2. The term enterprise also includes a participation in a partnership or joint business by an enterprise referred to in Paragraph 1.

Article V

Salaries and other remuneration derived by a resident of a contracting state employed as a member of the crew of a ship or aircraft operated in international traffic shall be exempt from tax in the other contracting state.

Article VI

The competent authorities of the contracting state shall seek to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of this agreement.

Article VII

Nothing in this agreement prevents a contracting state from taxing its residents and citizens.

Article VIII

Each of the contracting states shall notify the other contracting state in writing, through diplomatic channels, upon the completion of their respective legal procedures to bring this agreement into force. The agreement shall enter into force on the date of the later of such notifications and the provisions shall take effect on January 1, 1982.

Article IX

This agreement shall remain in force indefinitely. However, either contracting state may terminate the agreement by giving six months prior notice to the other contracting state, through diplomatic channels, in which case the agreement shall cease to have effect as of January 1 following the expiration of the six months period.

Done at Beijing this fifth day of March 1982, in duplicate, in the English and Chinese languages, the two languages texts having equal authenticity.

India: Finance Bill, 1982

Summary of Proposals relating to Direct Taxation

by Kailash C. Khanna

CORPORATE TAXATION

Tax relief has been proposed for Indian exporters whose export turnover during the accounting year exceeds the export turnover of the immediately preceding year by more than 10%. The goods in relation to which the tax concession will be provided and the rate at which the relief will be calculated will be notified by the Central Government after taking into account the cost of manufacture of such goods, the prices of similar goods in the foreign market, the need to develop foreign markets for such goods, the need to earn foreign exchange, the destination of export and any other relevant factors. The maximum amount of deduction to which the taxpayer will be entitled will not exceed 10% of the amount of income tax otherwise payable by the taxpayer on the profits and gains from the export of such goods.

With a view to encouraging construction, engineering and similar projects overseas, there is a proposal that where a resident Indian taxpayer derives any profit from the business of execution of a project under a contract with a foreign enterprise, he will be entitled to a deduction from taxable income of 25% of such profits, subject to certain conditions. First, 25% of the profits from the project should be credited to a special reserve account, which shall not be available for distribution by way of dividends or profits for 5 immediately succeeding assessment years. Secondly, the consideration for the project should be payable in foreign currency and the taxpayer will be required to remit into India in foreign exchange an amount equal to 25% of such profits within a period of 6 months from the end of the relevant accounting year. If the amount credited to the reserve account or the amount actually remitted into India is less than 25% of the profits of the project, the deduction will be restricted to the amount so credited or remitted, whichever is less.

It is proposed to extend, up to 31 March 1987, the grant of investment allowance now admissible at the higher rate of 35% to specified plant and machinery.

Another suggestion seeks to exempt from tax intercorporate dividends in the case of 3 more industries, namely, synthetic rubber, rubber chemicals and basis drugs.

PERSONAL TAXATION

No changes in the slab rates of tax have been proposed except in the following cases:

(1) on income between 60,001 and 70,000 Rs. – from 50 to 52.5%;
(2) on income between 70,001 and 85,000 Rs. – from 52.5 to 55%;
(3) on income between 85,001 and 100,000 Rs. – from 55 to 57.5%.

Under the existing law, deduction in respect of LIC premium, employee's contribution to Provident/Superannuation Fund, deposit of 10/15 Year Post Office Cumulative Time Deposit, etc. is allowed at the following rates:

- on 5,000 Rs. – 100%
- on next 5,000 Rs. – 50%
- on balance – 40%

It is now proposed to increase the rate of deduction as under:

- on 6,000 Rs. – 100%
- on next 6,000 Rs. – 50%
- on balance – 40%

It is also proposed to raise the maximum amount qualifying for deduction from 30,000 to 40,000 Rs.

At present, standard deduction is allowed to salaried employees at the rate of 20% of their salary subject to a maximum of 5,000 Rs. It is proposed to increase the rate to 25% without any change in the ceiling of 5,000 Rs.

Under the existing law, income up to 3,000 Rs. received by an individual by way of interest on Government securities, interest on certain debentures, dividends on shares in Indian companies, interest on bank deposits, etc. is exempt up to 3,000 Rs. It is proposed to raise the exemption limit from 3,000 to 4,000 Rs.

Encashment of unutilised earned leave received by employees of Central/State Governments at the time of their retirement will be exempt from tax without any limit; others will qualify for relief up to 6 months' salary or 25,000 Rs., whichever is less.

It is also proposed that the exemption limit of interest received from the Unit Trust of India should be raised from 2,000 to 3,000 Rs.

At present, investment in certain specified new equity shares by individuals qualifies for deduction at 50% of the cost of acquisition. This deduction is available only in the year of acquisition and up to a shareholding of 10,000 Rs. It is proposed to increase the amount of 10,000 Rs. to 20,000 Rs.

It is proposed to modify the provisions relating to exemption from capital gains on transfer of house property. The condition of self-occupation of the property by the taxpayer is intended to be deleted and the period for construction of a new property is proposed to be increased from 2 to 3 years. Likewise, capital gains arising from the transfer of certain long term capital assets will be entitled to tax exemption provided the net consideration is utilised by the taxpayer for the purchase or construction of a house property within the specified period. It is also proposed to relate the deduction in respect of long term capital gains to the period for which the capital asset has been held; higher deduction will be allowed if the capital asset is held for a longer period.

With a view to encouraging savings, it is proposed to issue a new series of capital investment bonds with a maturity period of 10 years carrying simple interest at

7% per annum payable annually. The interest on this bond will be exempt from income tax without any ceiling limit.
It has also bee proposed that the value of these bonds will be exempt from wealth tax without any ceiling limit.
Gifts of these bonds by the first holder up to 1,000,000 Rs. in one or more previous years will also be exempt from gift tax.

In order to encourage private savings, a Social Security certificate will be introduced. Under this scheme an individual between the age of 18 and 45 can invest up to 5,000 Rs. and the amount will triple in 10 years. The main feature of this scheme is that in the case of death of the investor during the 10-year period, his nominee or legal heir will immediately become entitled to the full maturity value of the certificate. The details of the scheme will be notified later.

WEALTH TAX

Under the existing law, exemption from wealth tax is available up to 150,000 Rs. representing shares in Indian companies, bank balance, Post Office Savings, etc. This limit is proposed to be raised to 165,000 Rs.

The value of conveyance(s) owned by an individual is now exempt from wealth tax up to 30,000 Rs. It is proposed to increase this limit to 75,000 Rs.

With a view to providing an incentive to increased savings, it is proposed to introduce a new capital investment bond. Investment in this bond will be exempt from wealth tax without any limit.

It is also proposed to raise the wealth tax exemption limit in respect of investment in a Unit Trust from 25,000 to 35,000 Rs.

Highlights of the Tax Proposals of the Indian Budget for 1982-83

by Dharmendra Bhandari*

With the Prime Minister, Shrimati Indira Gandhi, entrusting the Finance portfolio to Mr. Pranab Mukherjee, the youngest Finance Minister in India, just a few weeks before the presentation of the budget, it was expected that Mr. Mukherjee's budget would give a boost to the sagging Indian economy. However, the general feeling is that Mr. Mukherjee's maiden budget neither offers any solution to the problems which the Indian economy faces nor does it seek to give a fillip to the industrial growth of the country.

DIRECT TAXES

In framing his direct tax proposals, the Finance Minister has spelt out his motto thus: Save-invest-produce and get concession to export. In order to mobilise private savings for public use, the Government has decided to issue two new savings investments. Firstly, under the Social Security Certificates, an individual between the ages of 18 and 45 can invest up to 5,000 Rs. which will triple in 10 years. The second instrument is the Capital Investment Bond. These bonds will have a maturity of 10 years and carry an interest rate of 7%, exempt of income tax, wealth tax and, in the case of gift tax, up to 10 lakhs Rs.[1] in the case of the first holder.

It is proposed to increase the monetary ceiling of deduction in respect of Life Insurance, Provident Fund, etc., from 30,000 to 40,000 Rs. The Minister has also proposed to raise the ceilings for exemption of income from investment in specified financial assets such as bank interest, dividends, government securities, etc. from 3,000 to 4,000 Rs. and in case of units from 2,000 to 3,000 Rs. He has also proposed to double the amount of deduction of equity investment in new industrial companies and housing finance companies from 10,000 to 20,000 Rs. Further, with a view to providing an incentive to taxpayers who do not own a residential house, it is proposed to exempt from tax long term capital gains arising from the transfer of assets where the net consideration received is invested by the taxpayer in a residential house.

The Finance Minister has also proposed to boost investment in India by the large number of non-resident Indians working abroad. Firstly, any investment without repatriation rights made by non-residents of Indian origin, so long as it is not for transaction in commercial land, will be treated on the same footing as investments of resident Indian nationals. They will be allowed to invest, with repatriation rights, in any new or existing company up to 40% of the capital issued by such company. Secondly, the interest rates on new deposits of maturities of one year and above held in non-resident external accounts will carry interest of 2% above the rate permissible on local deposits held by persons resident in India. The test of "residence" as laid down for taxation purposes has also been liberalised to avoid hardship to Indian citizens earning income in foreign countries who come to India for short spells.

With a view to earning more foreign exchange, the Finance Minister has proposed a reduction in income tax on export profits for exporters whose turnover in 1982-83 is in excess of 10% of their turnover in the current year. In view of the large construction contractors working

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1. 1 lakh = 100,000.

outside India, 25% of their profits will be exempt from income tax subject to certain conditions.

INDIRECT TAXES

While giving concession in direct taxes, the Finance Minister has relied heavily on customs duties to raise revenues. His main proposal is to raise the auxiliary duty on all categories of imports by 5% except for petroleum products. Basic customs duties on several items such as polyester chips, electric goods and certain items of iron and steel have also been increased. There is a heavy increase in excise duty on cement which has been raised from 71.50 to 135 Rs. a tonne.

In order to boost production in certain industries like fertilizers, steel products, paper, etc., it is proposed to give excise duty concession for 38 industries on output in excess of 110% of their 1981-82 output.

There are several other tax proposals of little importance that it is difficult to focus attention on all of them. The numerous minor concessions, relaxations and incentives reflect a certain predilection to please diverse sections of the society – understandable in a year of likely mini general elections – but do not add up to a strategy of a growth-oriented budget.

INDIA:

Budget 1982-83 Aimed at Increase of Production and Saving

Extracts from the Budget Speech pronounced on 28 February 1982 by Mr. Pranab Kumar Mukherjee, Union Finance Minister.

See for a detailed discussion of the Indian tax system the Bureau's publication TAXES AND INVESTMENT IN ASIA AND THE PACIFIC

Sir, before I present my tax proposal, I would like to indicate the broad objectives I have kept in view. While we take comfort in our success in reducing inflation, it is of the utmost importance that the budget itself should not give rise to further inflationary expectations. Any large uncovered deficit beyond prudent limits is inherently inflationary. It also gives rise to adverse expectations with regard to the behaviour of prices. It is therefore my major concern to keep the budgetary deficit as low as feasible.

Another important objective is to avoid measures which would place undue burdens on the low-income and middle-income groups. These groups are the worst sufferers in time of inflation.

As I have already indicated, providing adequate incentives for increasing production and savings in the economy is a prime objective of this budget. Larger savings and increases in productivity can significantly help moderate inflationary pressures and also generate resources for development. The buoyancy in revenue and the decline in the rate of inflation in the environment of strong agricultural and industrial growth in 1981-82 confirm this.

Salaried taxpayers

Sir, coming now to direct taxes, my first proposal concerns salaried taxpayers. There have been many representations that the income-tax exemption limit should be raised, taking account of increases in the cost of living. I cannot accept, as a principle, that income limits for exemption from tax should be fixed with reference to cost of living. Nevertheless, I believe some relief to salaried taxpayers within the lowest taxable slab would be appropriate. At present, salaried taxpayers are entitled to a standard deduction equal to 20% of the salary, subject to a ceiling of Rs. 5,000. I propose to raise the rate of deduction from 20% to 25%, without disturbing the ceiling of Rs. 5,000. This will give a significant measure of relief to those with salaries up to Rs. 20,000. The loss of revenue would be Rs. 21.58 crores in 1982-83.

Another measure of relief seems deserved for those at the end of their working lives. I propose to exempt from income-tax, subject to certain conditions, the encashment benefit in lieu of unavailed earned leave given to employees when they retire.

Taxpayers who are not in receipt of house rent allowance are entitled to a deduction up to Rs. 300 per month in respect of the house rent paid by them. However, persons receiving house rent allowance are entitled to an exemption up to Rs. 400 per month in respect of the house rent allowance received by them. I propose to raise the monetary ceiling from Rs. 300 to Rs. 400 per month also for those who are not receiving house rent allowance.

The owner of a self-occupied house is entitled to a deduction, from the annual letting value of the house, of an amount equal to one-half of the annual letting value or Rs. 1,800 whichever is less. I propose to raise the monetary ceiling of Rs. 1,800 to Rs. 3,600.

The annual letting value of a newly-constructed house let out on rent has been reduced by an amount up to Rs. 2,400 in respect of each residential unit for a period of five years. With a view to providing a stimulus for construction of houses, particularly for persons with relatively lower incomes, I propose to raise the monetary limit of Rs. 2,400 to Rs. 3,600.

Long term saving

I propose to liberalise the scheme of deduction in respect of long-term savings such as life insurance, provident fund contributions, etc. A deduction of 100% will be allowed in respect of the first Rs. 6,000 of the qualifying savings, plus 50% of the next Rs. 6,000 of such savings plus 40% of the balance. The monetary ceiling in respect of the savings qualifying for deduction is also being raised from Rs. 30,000 to Rs. 40,000. The higher monetary ceiling in respect of the qualifying savings in the case of authors, playwrights, artists, musicians, actors, sportsmen and athletes, is also being raised from Rs. 50,000 to Rs. 60,000. These incentives for larger savings will result in a revenue loss of Rs. 26.17 crores in a full year and Rs. 19.76 crores[1] in 1982-83. It may be desirable in due course to provide a wider choice of eligible modes of savings to taxpayers. I therefore propose to extend the existing tax concession in relation to investment in notified Central government securities.

I find that out of the new life insurance policies issued by the Life Insurance Corporation of India, nearly 15% policies lapse before the end of the following year. Such a high volume of lapses shortly after the issue of the policies is a matter of concern. It also implies that the very purpose for which the tax concession is allowed in respect of premia on such policies, which is to promote long-term savings through life insurance, is frustrated. I propose, therefore, to provide that were a taxpayer discontinues a life insurance policy before premia for two years have been paid, no deduction will be allowed in respect of the premia if any paid under the policy and, if such deduction has been allowed, the same shall be withdrawn.

Under the existing incentives for stimulating savings and investment, income up to Rs. 3,000 from investment in specified financial

1. 1 crore = 10,000,000.

assets, such as government securities, units in the Unit Trust of India, bank deposits and shares in Indian companies, is exempt from Income-Tax. In addition income up to Rs. 2,000 from units in the Unit Trust of India is exempt from tax. I propose to raise the ceiling of Rs. 3,000 to Rs. 4,000 and the separate ceiling in respect of income from units, from Rs. 2,000 to Rs. 3,000. This measure will result in a revenue loss of Rs. 12.12 crores in a full year and Rs. 9.09 crores in 1982-83.

As a parallel measure, I propose to raise the ceiling of the value of investments in specified financial assets exempt from wealth-tax from Rs. 150,000 to Rs. 165,000. In addition, the separate exemption of Rs. 25,000 provided in respect of units in the Unit Trust of India is proposed to be raised to Rs. 35,000. The revenue loss will be Rs. 1.54 crores in a full year, but there will be no loss in 1982-83.

At present, taxpayers are allowed a deduction, in the computation of taxable income, of 50% of amounts invested in equity shares of new industrial companies and companies engaged in providing long-term finance for construction or purchase of houses for residential purposes. The maximum investment in a year qualifying for this deduction is limited to Rs. 10,000 with a view to encouraging larger investments in such companies. I propose to raise the monetary ceiling for investment to Rs. 20,000.

High incomes

While I have given some relief to those in the lowest taxable income range, I consider that there is scope for more progression in the tax rates for high incomes. I, accordingly, propose to modify the rates of personal taxation, so as to raise the rate of income-tax on the slab of Rs. 60,001 to Rs. 70,000, from 50% to 52.5%, and on the slab of Rs. 85,001 to Rs. 100,000 from 55% to 57%. This would yield Rs. 3.24 crores in a full year and Rs. 2.43 crores in 1982-83.

Withholding tax

Deduction of tax at source from dividends, interest on securities and other interest causes considerable inconvenience, and even hardship, to a large number of small investors whose taxable income is below the exemption limit. For the convenience of such persons, I propose to provide that income-tax shall not be deducted at source if the recipient furnishes a declaration to the payer of such income to the effect that his estimated total income of the relevant year will be below the exemption limit.

I also propose to provide that tax will not be deducted at source from interest paid on such securities of the central government or a state government as may be notified by the central government in this behalf.

Residence

The tests of "Residence" in India laid down for taxation purposes result in hardship to Indian citizens earning income in foreign countries who come to India for short spells. An individual is regarded as resident in India in a year if he stays here in that year for 30 days only, and also maintains a dwelling house here for 182 days or more. As this test causes hardship to persons working outside India, who come home even on relatively short visits, I propose to delete this test of residence.

Under another test, persons who have been in India for 365 days or more in the four years preceding the relevant year, become resident in that year by being in India for 60 days or more in that year. In the case of Indian citizens who are employed abroad and who come to India on leave or reaction, the period is 90 days. I propose to extend this benefit also to the self-employed and those in other occupations, irrespective of their avocation abroad or the nature of their visit to India.

Indian citizens who go abroad for purposes of employment are now chargeable to tax in India on their foreign income, if they have stayed in India for more than 60 days that year. I propose to liberalise the provision so that an Indian citizen who leaves India in any year for purposes of employment shall not be treated as resident unless he has been in India for 182 days or more in that year.

Foreign exchange earners

I will now come to some proposals regarding foreign exchange earnings. I propose to provide some tax relief to exporters whose export turnover for any year exceeds that of the immediately preceding year by more than ten percent. The tax relief, to be calculated at a specified percentage of such excess turnover, would be limited to ten percent of the income-tax otherwise payable on export profits. The rate at which the tax relief will be calculated and the goods qualifying for the purpose of this concession will be notified by the Central government.

With a view to strengthen the competitiveness of our construction contractors who have undertaken projects outside India, I propose to exempt 25% of the profits derived by them from such foreign contracts, subject to certain conditions.

With a view to augmenting the capital base of Indian banks engaged in banking operations in foreign countries, I propose to provide that those banks which are approved in this behalf by the Central government would be entitled to a deduction up to 40% of their income carried to a special reserve account.

Interest-tax levied under the Interest-Tax Act forms an integral part of our credit policy. However, taking note of the escalation in costs of industrial projects, I propose to exempt scheduled banks from payment of interest-tax on the interest received by them on loans sanctioned in foreign currency for import of capital plant and machinery. With a view to improving the competitiveness of export of capital plant and machinery, I propose to exempt interest paid on credit sanctioned by scheduled banks for export of capital plant and machinery on deferred payment terms outside India.

Incentives

Investment allowance at the higher rate of 35% is granted in respect of machinery and plant installed for the manufacture of articles made with know-how developed in government laboratories, public sector companies, recognised institutions and universities. This concession is available in relation to machinery and plant installed up to 31st March, 1982. I propose to extend this tax concession for a further period of five years.

Dividends received by a domestic company from an Indian company engaged exclusively or almost exclusively in the manufacture of specified articles are completely exempt from income-tax, having regard to the importance of basic drugs, synthetic rubber and rubber chemicals (including carbon black). I propose to extend the benefit of this tax concession to dividends received from companies engaged in the manufacture of these articles as well.

At present, scheduled commercial banks are allowed a deduction in respect of provisions made by them for bad and doubtful debts relating to advances made by their rural branches. The deduction is limited to 1.5% of the aggregate average advances made by the rural branches. In order to promote rural banking and to assist non-scheduled commercial banks operating in the rural sector, I propose to extend the benefit of this tax concession to them also.

Energy saving and protection of the environment are high priority areas. I, therefore, propose to allow depreciation at 30% on devices and systems for energy saving, or for minimising environmental pollution or for conservation of natural resources. The list of the qualifying items will be notified in due course.

At present, taxpayers are entitled to 100% deduction in respect of donations made to approved institutions engaged in carrying out programmes of rural development. I propose to extend this concession to donations made to approved institutions for use in programmes of conversation of natural resources.

Hon'ble members will be happy to hear that I propose to place donations made to the national children's fund at par with donations made to other funds of national importance such as the National Defence Fund, the Jawaharlal Nehru Memorial Fund, and the Prime Minister's National Relief Fund.

Capital gains

I consider that some rationalisation of the taxation in respect of capital gains is desirable. In the case of non-corporate taxpayers, long-term capital gains up to Rs. 5,000 are deducted in full. Of the balance amount, a deduction of 25% is allowed where the gains relate to lands and buildings and of 40% where the gains relate to other assets. I propose to modify these provisions so as to relate the deduction to the period for which the capital asset has been held by the taxpayer, and allow a larger deduction in cases where the asset has been held for a longer period. The aggregate deduction in respect of capital gains relating to gold, bullion or jewellery will, however, be restricted to Rs. 50,000 only.

There is an acute shortage of housing, and house building activity has to be given impetus. With a view to providing an incentive to taxpayers who do not own a residential house, I propose to exempt from tax long-term capital gains arising from the transfer of other assets where the net consideration is invested by the taxpayer in a residential house.

At present, capital gains arising from the transfer of a house used for personal residence by the taxpayer are exempt from income-tax to the extent that such gains are utilised by the taxpayer for constructing or purchasing a house for purposes of personal residence within a specified period. These conditions often lead to hardship. I, therefore, propose to remove these restrictive conditions.

Charitable and religious trusts are required to conform to the investment pattern laid down in the Income-tax Act. Any trust which has not changed over to this pattern of investment will forfeit exemption from tax from the assessment year 1982-83. These trusts have been given adequate notice to change their investment pattern and, ordinarily, I would not have proposed any modification in these provisions. However, I find that the whole gamut of the provisions relating to charitable and religious trusts is under consideration by the economic administration reforms commission. As the government would like to carefully consider the recommendations of the commission in this matter, I propose to amend the relevant provisions so that such trusts do not forfeit exemption from income-tax for the assessment year 1982-83.

My distinguished predecessor had made an announcement in the Lok Sabha on March 31, 1981 that the provisions of the Income-tax Act relating to the investment pattern of trust funds would be modified. So as to permit charitable and religious trusts or institutions to invest the trust funds in immovable properties as well, I am proposing an amendment of the relevant provisions of the Income-tax Act to fulfil the assurance given by him.

Wealth tax

While the levy of wealth tax on agricultural property was discontinued by the Finance (No. 2) Act, 1980, owners of tea, coffee, rubber and cardamom plantations continue to be chargeable to wealth tax. Our experience is that the valuation of agricultural land forming part of such plantations leads to administrative difficulties, complaints of harassment and litigation. The yield from this levy is also insignificant. I, therefore, propose to discontinue to levy of wealth tax on such plantations as well.

The value of tools and instruments necessary to enable the taxpayer to carry on his profession or vocation is exempt from wealth tax up to an aggregate amount of Rs. 20,000, which appears inadequate. I propose to raise it to Rs. 50,000. I also propose to raise, from the present Rs. 30,000 to Rs. 75,000, the ceiling of the value of conveyances, including motor cars, for the purpose of exemption from wealth tax.

Gifts

Stamp duty paid on an instrument relating to the gift of any property is allowed as a deduction from the gift tax payable by the taxpayer in cases where the amount of gift tax exceeds Rs. 1,000. I propose to allow the benefit of this deduction even where the gift tax payable does not exceed Rs. 1,000.

Luxury hotels

The Hotel Receipts Tax Act, 1980 provides for the levy of a tax on the gross receipts of luxury hotels. As the levy of this tax may adversely affect the flow of foreign tourists into India, I propose to discontinue this levy in relation to the chargeable receipts of such hotels accruing or arising or received by them after the 27th February, 1982. The revenue loss would be about Rs. 6 crores.

. . .

Auxiliary customs duties

Mr. Speaker, sir, I now turn to the area of indirect taxes. Taking customs duties first, my principal proposal is with regard to auxiliary duties of customs. This levy, which has been imposed on an annual basis since the 1973 budget, is proposed to be continued during 1982-83. The balance of payments position has been continued during 1982-83. The balance of payments position has been under pressure in recent times and will continue to be so for some time to come. However, a liberalised regime of imports has been a feature of our economic policies. This will be continued in order that investment and production, particularly in essential and priority sectors, are not hampered or slowed down. There is no strong reason, however, where those who have access to imports in a difficult situation should grude to pay a little more. I accordingly propose to increase the rates of auxiliary duties by five percentage points on all categories of imports, which some exceptions.

I am excluding from the proposed increase in auxiliary duty essential items like crude petroleum, bulk petroleum products, such as kerosene and high speed diesel oil, and some other items on which import duty rates have been adjusted in the recent past on price parity considerations. Fuller details of these proposals are available in the budget papers.

My proposals relating to auxiliary duties of customs are expected to yield an additional revenue of Rs. 290 crores.

Basic customs duties

In the light of the present market conditions, and the need for encouraging a few selected industries, it is necessary to effect certain changes in the basic customs duties. I propose to raise the basic customs duty on cork and cork articles from 40% to 60% ad valorem; on certain categories of dyestuffs, from 60% to 100% ad valorem; and on certain other categories of dyestuffs, pigments and colours and paints and varnishes, from 100% to 150% ad valorem. I also propose to increase the basic customs duty on certain items of iron and steel, such as melting scrap of stainless steel and heatresisting steel, and certain categories of alloy steel excluding stainless steel and heat-resisting steel, from the existing levies to 60% ad valorem. The effective rate of basic customs duty on copper pipes and tubes, blanks and hollow bars of prescribed specifications will be increased from 40% to 60% ad valorem. The basic customs duty on polyester chips is being increased from 100% to 140%. These proposals are likely to result in additional revenue of Rs. 42 crores.

It may be recalled that in the last budget, an effective customs duty of 15% ad valorem was imposed on imported newsprint on which there continues to be large foreign exchange outgo. The government has received representations against this levy. I propose to convert the ad valorem levy to a specific total levy of Rs. 825 per metric tonne so as to obviate automatic increase in its incidence on account of rising international prices. There will be no revenue loss.

The indigenous zinc and lead industries are facing difficulties owning to escalation of input costs, particularly of imported concentrates. In order to enable them to increase their capacity utilisation, I propose to reduce the total customs duty incidence on imported zinc concentrates from 50% to 15% ad valorem and that on lead concentrates from 50% to 5% ad valorem. Simultaneously, I propose to increase the customs duty on imported zinc metal from 50% advalorem to 60% ad valorem. In order partly to offset the revenue loss, I propose to increase excise duties on indigenously produced, zinc metal, zinc scrap and zinc products by Rs. 715 per metric tonne and that on lead metal and scrap by Rs. 374 per metric tonne. The excise duty on zinc pipes and tubes will go up from 38.5% to 49.5% ad valorem. These measures, taken together, would result in an overall loss of about Rs. 41 lakhs.

With a view to improving the competitive position of Indian chromite ore in the context of falling prices in the export market, I propose to convert the existing specific rates of export duty applicable to different grades of the ore and concentrates to an ad valorem duty of 10%. The revenue sacrifice is of the order of Rs. 1 crore.

I also propose to fully exempt two fertilisers – calcium ammonium nitrate and ammonium sulphate from customs duties. The import duty on internal combustion engines and non-interchargeable parts of such engines for manufacture of power tillers is also proposed to be reduced from 125% to 50%.

I propose to fully exempt 10 more bulk drugs imported for manufacture of life-saving drugs and medicines. Details are being notified.

During the past few years, the government has been using the fiscal mechanism for accelerating the growth of the electronics industry. As a further step in this strategy, I propose to raise the basic customs duty on electronic items such as computers, calculating machines, accounting machines, cash registers and certain electronic sub-assemblies from the existing levels of 40, 50 and 60% to 100% ad valorem. On the other hand, I propose to extend the scope of the present import duty concessions to cover 45 new items of capital equipment and 13 new items of raw materials and components used by the electronics industry. The customs duties leviable on these items are proposed to be reduced from the respective existing rates to 53% ad valorem in the case of machinery and instruments and to 55% ad valorem in the case of raw materials and components. The net revenue gain from these proposals is Rs. 13 crores.

Free trade zones

Representations have been received that it is not always possible for units in the free trade zones to export their entire production, and that a provision should be made to allow a proportion of the goods manufactured in these zones to be cleared into the domestic tariff area. It has been decided, subject certain conditions, to allow such removals up to 25% of the production of a unit for sale or use within the country on payment of appropriate duties. Provision is being made in the Finance Bill to amend the Customs and Central Acts for the purpose.

Excises

On the Central excise side, the levy of special duties of excise is proposed to be continued at the existing rates during the year 1982-83. The existing exemptions from the special duty are also proposed to be continued.

As I said earlier, my basic approach has been that additions to revenue from Central excise duties should essentially come from increased production. I am also avoiding recourse to measures which could affect retail prices over a wide spectrum of goods. I have accordingly selected only a very few items for increased taxation. In selecting these items, I have kept in view the demand and supply situation which has resulted in undue profits to trading channels, the scope for subjecting certain articles of elite consumption to a higher rate of tax, and the need to restructure the excise and customs duties applicable to certain basic industries.

The government has decided to introduce scheme of "levy" and "free" sale of cement, and a dual pricing policy based on this concept. Details of the new scheme are being notified by the government separately. There has been no increase in the low level of basic excise duty on cement since January, 1977, even though thereafter the price of cement has increased very substantially. I propose to increase the total excise duty on ordinary portland cement, portland pozzolana cement, blast furnace slag cement and masonry cement, from Rs. 71.50 to Rs. 135 per metric tonne. The more expensive special varieties of cement will be subject to higher rates of duty. The effective total excise duty on cement produced in mini cement plants is proposed to be fixed at Rs. 100 per tonne.

I also propose to impose a basic customs duty of 10% ad valorem on imported cement, together with full countervailing duty. No auxiliary duty would be leviable on imported cement. These proposals will give additional revenue of Rs. 158.73 crores on the central excise side and Rs. 39.60 crores on the customs side. The impact of the proposed increase in excise duty per bag of cement of 50 kilograms would work out to Rs. 3.175.

Electronic appliances

In the recent past, certain expensive electronic goods favoured by the affluent are being produced in increasing quantities. These are now subjected to a very low incidence of duty at eight percent ad valorem under item 68 of the central excise tariff. I now propose to carve out new entries in the excise tariff, and subject video cassette recorders and reproducers, television cameras and video cameras, and similar goods to a basic excise duty of 25% ad valorem. Blank and recorded video and audio tapes of the spool and cassette types, as also video discs, are also proposed to be subject to a basic duty of 25% ad valorem. Recordings which are not for commercial purposes will be exempt. I also propose to levy basic duty at a higher rate of 40% on electronic machines for games of skill or chance, including those used for television games and video games. These proposals would yield revenue of Rs. 3.83 crores.

Toilet preparations

Toilet preparations not containing alcohol are liable to central excise duty at the basic rate of 100% ad valorem whereas those containing alcohol attract duty under the Medicinal and Toilet Preparations (Excise Duty) Act at only 60% ad valorem or Rs. 13.20 per litre of pure alcohol content, whichever is higher. Some misuse because of these differential rates has come to notice. I, therefore, propose to raise the alternative ad valorem rate of 100% ad valorem so as to place both categories of toilet preparations more or less at par. The revenue yield from this measure is expected to be Rs. 2.3 crores and would accrue mostly to the states.

Textiles

Hon'ble members may recall that the textile policy statement of March, 1981 envisaged a review of fiscal levies on man-made fibres and yarn. While cotton will continue to enjoy the predominant position in textiles, it is necessary to encourage increased consumption of blends of cotton and man-made fibres and yarns, if we are to achieve the plan target of even a modest increase in the per capita availability of cloth. For some time past, blended fabrics containing polyester fibre in proportions too small to impart the requisite durability and easycare properties to the fabrics are flooding the market with stampings thereon which would mislead the public.

From the point of view of better utilisation of polyester fibre, it is necessary to encourage blends of desirable proportions, and discourage blends which do not really serve the intended purpose. I therefore propose to make certain changes in the fiscal levies applicable to man-made fibres and yarns. I propose to increase the duty on blended cotton yarn and cellulosic spun yarns containing up to one-sixth by weight of polyester fibre from the existing average total incidence of Rs. 1.63 per kilogram to Rs. 7.5 per kilogram. The total incidence on such blended yarns containing more than one-sixth but less than 50% of polyester fibre, which seems to be desirable blends in Indian conditions, is proposed to be reduced from Rs. 22.50 per kilogram to Rs. 11.25 per kilogram. Similarly, the incidence on blends containing 50% or more but less than 70% of polyester fibre is being reduced from Rs. 30 per kilogram, to Rs. 22.50 per kilogram. There will be no change with regard to blends containing 70% or more of polyester fibre.

It is proposed to increase the total incidence of central excise duty on acrylic fibre from Rs. 12.50 to Rs. 17.50 per kilogram and simultaneously to reduce the countervailing duty on imported fibre from Rs. 37.50 to Rs. 30 per kilogram.

Turning to viscose staple fibre the excise duty is being raised from Rs. 3.12 per kilogram to Rs. 4 per kilogram and the duty on polysonic and high wet modulus fibres is being reduced from Rs. 5 to Rs. 4 per kilogram.

Acetate filament yarn which is used in the decentralised sector is not produced in adequate quantities in the country. It is proposed to reduce the customs duty on it from 125% to 20% ad valorem so as to facilitate imports of this yarn.

I do not propose to change the excise or basic customs duty rates applicable to other fibres such as acetate fibre and polyester fibre and other filament yarns such as viscose, nylon and polyester filament yarn.

These proposals would result in a net loss of Rs. 13 crores on the central excise side and a gain of Rs. 12.94 crores on the customs side.

At present, there is no basic duty leviable on man-made fabrics, the incidence of such duties having been shifted to the fibre and yarn stages. These fabrics attract only additional excise duties in lieu of sales tax. While the present rate structure is progressive on fabrics having ex-factory price up to Rs. 10 per square metre, it is not so in respect of the higher priced fabrics since the duty applicable to them is a uniform 5.5% ad valorem. There are very high-priced fabrics in this range, catering to affluent consumption, and these fabrics can well bear a moderate increase in duties. I therefore propose to introduce further progression in the rate structure in such a way that fabrics having ex-factory prices of more than Rs. 20 per square metre would attract duty at 7.5% ad valorem. The additional revenue from this proposal is estimated at Rs. 35 crores, which will go to the States. The proposal would also be a step towards fulfilment of the Centre's commitment to the State to increase the overall incidence of additional excise duties in lieu of sales tax, as a percentage of the value of clearances. I am sure that Parliament and the States would whole-heartedly welcome this step.

The overall effect of the duty changes on blended fabrics containing cotton, cellulosics and polyester would be a decrease in the price of desirable blends and an increase in the price of the other less desirable blends.

I have included in the Finance Bill some provisions designed to achieve simplification and greater clarity in the tariff nomenclature and thereby minimise the scope for classification disputes. These measures are not designed as revenue raising exercises, but because of the changes in classifications, some revenue will accrue. The proposals cover, among others, major petroleum products, artificial and synthetic resins and plastic materials.

Paper

I also propose to rationalise and restructure the tariff relating to paper and paper boards, the primary objective being to exempt small scale paper converters from payment of excise duty and to release them from excise control. In order to recoup the consequent loss in revenue, I propose to raise the basic excise duty on industrial varieties of paper and paper boards by a small margin of 2.5% ad valorem. However, certain converted papers of high value-added categories are proposed to be subject to basic excise duty at 32.5% ad valorem. Similarly, specified articles made of paper and paper board are proposed to be brought within the purview of the tariff item but effectively restricting the levy to printed cartons and printed boxes.

Tyres

In recent years, the scheme of input excise duty relief has been extended to cover certain specified industrial products. I propose to further extend input duty relief in respect of synthetic rubber, carbon black and rubber processing chemicals going into the production of tyres. To make up for the revenue loss, I propose to raise the duty leviable on tyres from a total of 60.5% to 66% ad valorem. While tyres for tractors and scooters will also enjoy the benefits of the input duty relief, I do not propose to increase the final duty rates on them. As this is intended to be a balancing exercise, no credit for additional revenue is being taken.

Aluminium

As the House is aware, the administered price of aluminium metal is revised periodically, keeping in view escalations in input costs. In order to contain the incidence of excise duty, it is proposed to levy duty at specific rates. The rates would be Rs. 3,085 on electrolytic grade ingots, Rs. 3,125 on billets, Rs. 3,330 on wire rods produced by primary producers and Rs. 3,280 on wire bars. There would be no change in the rates of countervailing duties. The proposal will give some relief to the finances of State Electricity Boards.

Glass

As an anti-avoidance measure, I propose to add to the present ad valorem levy on flat glass, a specific levy at the rate of Rs. 5.50 per millimetre thickness per square metre. Effective rates of duty are being prescribed at lower levels for different categories of flat glass.

Biri

The Government has received a large number of representations alleging malpractices in the biri industry, on account of the present differential rates of excise duty applicable to branded and unbranded biris. Many state governments and associations have urged that this distinction should be done away with. A suggestion to the same effect has also been made in a recent meeting of labour ministers. Taking note of these points, I propose to do away with the existing duty differential and to subject both branded and unbranded biris to a uniform composite duty rate of Rs. 3.60 per thousand. Simultaneously, the existing quantum of unbranded biris eligible for duty free clearance is also being reduced from 30 lakhs to 20 lakhs in a financial year. This would still leave self-employed family units, petty shop-keepers, etc. out of the tax net.

Aerated water

The general scheme of excise duty concession applicable to small manufacturers of 72 specified groups of commodities is being extended to manufacturers of asbestos fibre and yarn. Some misuse of the scheme with a view to avoiding excise duty on popular brands of aerated waters has come to notice. I therefore propose to take aerated waters out of the scope of the general scheme and devise a new scheme for it. Essentially, small manufacturers who sell their products under their own brand or trade names would continue to enjoy the benefits available under the present scheme. However, manufacturers who produce and bottle aerated waters under brand or trade names in pursuance of agreements with the owners of such brand or trade names would not be eligible for the concession. This also is purely an anti-avoidance measure.

Dyestuffs

The general scheme referred to earlier seems to have been similarly exploited by certain small manufacturers of synthetic organic dyestuffs. Under the present scheme, clearances up to Rs. 7½ lakhs are fully exempt and an additional Rs. 7½ lakhs are subject to duty at ¾ths of the duty rate applicable to the organised sector. In view of the relatively high rate of duty on dyestuffs and the fact that techniques of production of some dyestuffs are comparatively simple, it appears there has been a proliferation of small units with consequent deleterious effects on the quality, and also on the industry as a whole and on exports. I, therefore, propose to delete dyestuffs from the purview of the general scheme.

Under a new scheme which is being announced in respect of dyestuffs, very small manufacturers whose clearances do not exceed Rs. 1 lakh per annum will be fully exempt from excise duty. In the case of other small manufacturers, clearances up to Rs. 15 lakhs of dyestuffs will be subject to 50% of the duty applicable to the organised sector. All manufacturers will be brought under excise control. The monetary content of the present scheme of relief is, by and large, maintained under the new scheme.

Electronic goods

At present, certain specified consumer electronic goods manufactured in the small sector attract duty rates lower than the normal rates. To restrict this duty concession to genuine small manufacturers, it is proposed to restrict the scheme of duty exemption to manufacturers with total anmnual turnover not exceeding Rs. 2 crores.

Matches

With regard to the match industry, I do not propose to disturb the existing duty structure. Small manufacturers whose clearances have not exceeded 150 million matches in the preceding financial year would continue to be eligible for the concessional rate of duty of Rs. 1.60 per gross boxes on clearances up to 120 million matches in the financial year. The concession will not be available if the matches are marketed under the labels of manufacturers who pay duty at Rs. 4.50 or Rs. 7.20.

As Hon'ble members are aware, the government has been using the excise duty mechanism as a powerful incentive for the growth of the cottage sector of the match industry. A number of manufacturers in the middle sector have, however, challenged in courts of law, the excise concession scheme for the cottage sector and obtained judgements in their favour. This may result in refund of substantial amounts of duty to the middle sector units. As the element of duty at the higher rate would have already been passed on to the millions of consumers, any refund of such duties would only result in unjust enrichment. A provision has been made in the Finance Bill to obviate this contingency.

Assessable value

There have been some disputes in the recent past regarding the determination of assessable values of excisable goods from a given cum-duty price, resulting in considerable litigation. This has resulted in locking up substantial amounts of revenue. It is proposed to suitably amend section 4 of the Central Excise and Salt Act to make it clear that in computing the amount of duty of excise deductible from the cum-duty price, the effective amount of duty of excise payable on the goods under assessment shall alone be taken into account. This amendment is being given effect to, retrospectively from 1st October, 1975.

Captive consumption

It has been the long-standing practice to charge excise duty on goods used for captive consumption within the factory where they are produced. Some doubt had, however, been cast on this position as a result of judgements of some High Courts, which interpreted certain provisions of the Central Excise Rules to hold that duty could not be collected on such goods as they had not been 'removed' from the factory. A number of manufacturers have also obtained stay orders from courts based on the same grounds. The matter has been taken up in appeal. Nevertheless, in order to place the position beyond doubt, the relevant Central Excise Rules have been suitably amended. A provision has also been included in the Finance Bill so that these amendments will have retrospective effect and the collections of duty made in accordance with the existing practice will also be validated.

Productivity Year

As the House is aware, 1982 has been designated by the Prime Minister as the "Productivity Year". With the improvement in infrastructural facilities, it is hoped that industrial production would register further growth in the current year. The fiscal mechanism could be judiciously deployed in furthering this objective. With this in view, I propose to formulate a scheme of excise duty concession for increased production of goods during the period of 12 months commencing on the 1st March, 1982 and ending on the 28th February, 1983. The scheme would cover 38 tariff items including some basic raw materials, other important industrial inputs and certain finished products. Some of the items are caustic soda, fertilisers, synthetic resins, steel ingots and steel products, internal combustion engines, wires and cables, two and three wheeled motor vehicles, light and heavy commercial vehicles, tractors, railway wagons, man-made fibres and filament yarn, tyres and writing and printing paper. A full list may be found in the Budget papers. The benefits of the scheme would accrue only in cases where the production in the 12 months period referred to above exceeds 110% of the production during the base period, namely, the 12 months ending on the 28th February, 1982. The duty concession would be 1/5th of the total amount of duty paid on the excess production computed, as explained earlier, in respect of goods carrying basic excise duty of 20% ad valorem or less, and 1/10th of the duty in other cases. The amount so computed for the whole period would be given as a credit which may be utilised for payment of Central excise duty during the financial year 1983-84.

The scheme will apply also to small scale manufacturers, who actually pay duty. It is proposed to ensure that those small scale units which are eligible for the benefits of the relevant excise duty concession schemes and are within the respective cut-off points during the year 1981-82, would continue to be eligble to the said benefits in 1983-84, even if they produce and clear goods in excess of the eligibility limits in the productivity year.

I am sure that industry will rise to the occasion and respond to this generous gesture of the government and achieve new peaks of production. Since the government would also be a beneficiary of the higher production in the shape of increased collection of excise duties, I do not propose to take any amount as revenue loss on account of the proposed concession.

Common consumption

I have already referred to the need to minimise the impact of my proposals on the middle and poorer sections of society. I propose to go further and give some concessions on articles of special interest to those sections. I propose to partially or fully exempt from excise duties several articles of common consumption. Some of these products are of interest to the student community, some are of general utility, yet others of interest to the disabled and one in the interest of horticulture. I propose to fully exempt from excise duty, pencils, erasers, pens including ball point pens and refills, laboratory glassware, enamelware, thermos flasks and parts, water coolers, candles, tooth brushes, spectacles and spectacle frames, one-day alarm clocks, domestic water filters, handpumps, Braille typewriters, invalid carriages and helmets. Further, I propose to reduce the basic excise duty on specified fruit and vegetable preparations from 15% to 10% ad valorem. I also propose to increase the present value limits of Rs. 15 per pair of footwear for eligibility to full duty exemption, to Rs. 30 per pair. Lac is also being exempted. In order to reduce the packaging cost involved in the sale of milk in laminated paper packs, I propose to exempt from excise duty low density polyethylene film and paper to be used by the Indian Dairy Corporation for the manufacture of such paper packs. This measure should enable larger marketing of milk in paper packs which have a longer shelf life, and also help in the fuller utilisation of surplus milk produced in flush seasons.

At present, mopeds of engine capacity up to 75 cc bear a reduced rate of excise duty of 10% ad valorem. This fuel-saving personalised conveyance is becoming increasingly popular particularly in urban and semi-urban areas. I propose to extend the concession to mopeds of engine capacity to 100 cc which are expected to be more fuel-efficient.

I had referred earlier to certain adjustments of excise and customs duties consequent on a review of the fiscal levies on man-made fibres and yarn. The production of blended cloth in the handloom sector is at present around 12 million metres. In order to enable the handloom sector to register faster growth, I propose to fully exempt from excise duties polyester blended fabrics woven on handlooms from processing stage duties if they are processed in factories set up by the state handloom development corporations or apex co-operative societies approved in this behalf by the Central government. This concession involves a revenue loss of Rs. 4 crores. I also propose to exempt metallised man-made filament yarn from the whole of the excise duty considering its use in saris and the like. The value of this concession is about Rs. 1 crore.

These excise duty concessions I have just referred to entail a total revenue sacrifice of Rs. 13.77 crores in a full year.

Where the changes are to be made by notifications effective from 28th February, 1982, copies thereof will be laid on the table of the House in due course.

My proposals will yield a net sum of about Rs. 196.13 crores from excise duties and Rs. 391.35 crores from customs duties. The yield from duties under the Medicinal and Toilet Preparations (Excise Duties) Act will be Rs. 2.30 crores in a full year. Taking all the proposals together, the net accrual to the Central exchequer in a full year will be Rs., 487.60 crores and that to the states will be Rs. 102.23 crores.

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UNITED KINGDOM:

Budget 1982-83

A Budget for Industry and Jobs

Extracts from the Budget Speech pronounced on 9 March 1982 by the Chancellor of the Exchequer, Sir Geoffrey Howe.

A discussion of the U.K. Budget will appear in the International Bureau of Fiscal Documentation's tax journal: EUROPEAN TAXATION.

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This will be a Budget for industry – and so a Budget for jobs. But it will be a Budget for people as well. It is a Budget that will strengthen the foundations of economic recovery.

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So this afternoon, I want to remind the House once more of two figures that virtually tell it all. Since 1960 the real purchasing power of the average citizen in Britain has risen by over two-thirds. But the real rate of return on the capital employed in British industry has fallen by five-sixths. In other words, our present living standards have for years been plundered from the store of investment for the future.

Nor have we put to good use the investment that has been made. Too often we have tried to mitigate the inescapable consequences of poor productivity and shrinking international competitiveness, by clinging to manning levels that could not be sustained.

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REDUCTIONS IN TAXATION

Although most of the measures which I shall announce today involve reductions in taxation, I am also proposing some additions to public expenditure, totalling some £350m in 1982-83. This includes an increase of £150m in the Contingency Reserve to accommodate some of the expenditure measures: this brings the reserve in 1982-83 to £2,400m. The planning total for 1982-83 given in the White Paper is £115.15bn, in cash, compared with £110.2bn which is the cash equivalent of last year's projections for 1982-83. But the increases I now propose will be more than offset by other changes in costs, and the total will therefore be £114.9bn.

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CHARITIES

The Government is deeply conscious of the contribution to our national life that is made by many of our charitable organisations. Two years ago, I introduced substantial new tax relief for convenated donations to charities. I also doubled the exemption from capital transfer tax for charitable bequests or gifts made within one year of death.

We have been urged to relieve charities from VAT on their purchases. The attractions of this are obvious. But it raises substantial difficulties. The more one studies how it might be done – and we have looked into it exhaustively – the more insuperable appear the problem of definition of administration and of equity that stand in its way. So, reluctantly, I have had to be satisfied with other ways of helping charities instead.

First, I propose to take the Capital Transfer Tax exemption for qualifying gifts to charities a stage further, by increasing it, for gifts made within a year of death, from £200,000 to £250,000.

Secondly, I intend to abolish Stamp Duty completely on transfers of assets to charities.

Thirdly, as the National Council for Voluntary Organisations has suggested, I propose to remove beyond all doubt any liability to Development Land Tax where a charity disposes of property which has been subject to roll-over relief.

Taken together, these measures constitute significant new assistance to charities and voluntary organisations. They build still further upon the significant benefits which charities have derived from earlier action by this Government. Our record continues to be one in which we can justifiably take pride.

DISABLED

I now come to the particular problem of the disabled which we have always had very much in mind. Last year, the International Year of the Disabled, I introduced a range of value added tax reliefs for charities concerned with the disabled. I am now able to announce three further measures of help.

First, there will be some extension of the existing VAT reliefs for disabled people and the charities serving them.

Secondly, mobility allowance. The rate will be increased – by more than the expected rise in prices – from £16.50 a week to £18.30. This will mean that it has risen by over 80% since the Government took office. This represents a considerable increase in real terms.

In addition I propose this year to respond to a particularly important request made on behalf of the disabled to successive governments in recent years. I propose that from 6 April the mobility allowance should be wholly exempt from income tax. This is a major step: it means an increase in net income of up to £5 a week for the working disabled. They deserve every encouragement, and the change will, I know, be widely welcomed.

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NATIONAL INSURANCE SURCHARGE REDUCED

I now turn to what can be done in this Budget directly to benefit business, industry, and hence jobs.

Our prime purpose is to help private commerce and industry to help itself, by cutting its costs. And I have no doubt, from the representations I have received, that the single measure business would most welcome is a reduction in the National Insurance surcharge.

This surcharge was imposed and then increased by the previous Government. Indeed, in their last two-and-a-half years in office, the last Government increased the combined charge on employment, the employers' National Insurance contribution and the National Insurance surcharge, from 8½% to 13½%.

The surcharge is, of course, a tax on employment. It raises production costs. It is not rebatable on exports and it either puts up prices or cuts into profits. But it is an extremely cost-effective tax. It raises large amounts of revenue, at little administrative cost. It is much easier to put on a tax of this kind than to take it off.

This Government has already protected businesses, and so employment, from any increase in employers' National Insurance contribution rates for two consecutive years. Had we not done so, employers would have had to find nearly £1 billion more in the coming year than will actually be the case.

It is now time to offer more positive relief. I accordingly propose to cut the rate of the National Insurance Surcharge from 3½ to 2½%. This will help to reduce costs throughout the economy and will be of value to all businesses, whatever their tax position.

The cut will operate from August 2, which is the earliest practicable date.

But I am anxious that industry should not suffer from this unavoidable delay. I shall therefore propose an extra ½% reduction between August 1982 and April 1983. The effect of this will be to ensure that business as a whole will enjoy in the last two-thirds of 1982-83 the equivalent of a whole year's reduction of 1% in the surcharge.

The proposal is intended to reduce business costs in the private sector. However public sector employers also pay the surcharge, and in order to leave them exactly where they would have been without the change, appropriate reductions will be made in the relevant cash limits and the Votes of central government and the NHS, in the Rate Support Grant to local authorities, and in the External Financing Limits of the nationalised industries. The necessary changes will be announced as soon as possible. This will reduce the cost to a net figure of £640m in 1982-83.

The aim of the relief I have just announced is to help business costs and employment. If it were to find its way into higher pay, that would totally defeat the object of the exercise, and would obviously have to be taken into account in future.

It is crucial that this should not happen. In proposing this reduction, we are offering business and industry, management and workforce, an exceptional opportunity to improve their own performance and prospects. I believe that they will take it.

NO CHANGES OF VAT RATES: EXCISE DUTIES UP

I come now to the indirect taxes. I propose no change in the rate of VAT.

For the excise duties there has grown up in recent years a sensible presumption that they should be adjusted in line with the movement in prices from one year to the next. That, after all, is what happens automatically with VAT and the ad valorem duties, and also to the personal tax allowances, unless parliament decides otherwise. And that is the basis of my approach to excise duty changes this year.

I start with the duty on tobacco. Last year the duty was increased twice – March as part of the Budget measures and in July to help recoup the loss of revenue from the derv duty reduction.

I have taken account of that in proposing this year an increase that is the equivalent of 5p, including VAT, on the price of a typical packet of 20 cigarettes. There will be consequential increases for other tobacco products. These changes will take effect from midnight on Thursday.

Next, alcoholic drinks. I propose to increase the duties from midnight tonight by amounts which represent about 2p on the price of a typical pint of beer, 10p on a bottle of table wine, and 13p on a bottle of sherry – all including VAT. The full increase in the price of a bottle of spirits necessary to take account of inflation would have been over 50p. However, in the light of the representations about the state of the Scotch whisky industry which I have received from hon. friends representing Scottish constituencies and others, I have decided that it would be appropriate to limit the increase on spirits to 30p a bottle, again including VAT.

Next, the oil duties. Last year, as the House will recall, I felt it right to go some way to meet the representations made to me by hon. members in favour of a lower increase in the case of derv than of petrol, in view of the impact of derv duty on industrial and distribution costs. I have decided this year slightly to widen that differential.

There is a strong case for a larger increase in the petrol duty than in the other duties, for our average pump prices are currently among the lowest in the European Community. They have moreover been favourably affected by the recent changes in the price of oil. Pump prices have been falling rapidly.

Against this it has been impressed upon me by a number of my hon. friends from rural constituencies, in all parts of the kingdom, that pump prices in remote areas are very much higher than those in more heavily populated areas. Yet dependence on cars for transport is greatest in the more scattered communities.

On balance, I think it would be right, at least at this stage, not to impose any real increase in the oil duties. I propose, therefore, to limit the increases in the duties on both petrol and derv to amounts which no more than compensate for one year's inflation. The duty on petrol will accordingly increase by the equivalent, including VAT, of about 9p a gallon or 2p a litre. This will still leave most pump prices lower than they were at the end of last year. The duty on derv will increase by the equivalent, including VAT, of about 7p a gallon or 1.5p a litre. As almost all derv is used by businesses, this smaller increase will help to hold down business costs.

As last year, I propose no change in the rate of duty on heavy fuel oil. I am not able, as some would wish, to cut the rate, but leaving it unchanged will help industry as the duty burden continues to fall in real terms.

Last year I undertook to review the rate of duty applied to aviation gasoline, or AVGAS. I have given very careful consideration to the reppresentations which I have received on behalf of air taxis, flying schools, crop-spraying and other specialist services, and from those concerned with air travel in the Highlands and Islands of Scotland.

I cannot accept in full the arguments which have been put to me, but I have decided that it would be right to reduce the AVGAS duty rate to one-half of that on petrol. Including VAT, this amounts to a reduction of about 32 pence a gallon or 7 pence a litre.

All these changes take effect for oil delivered from refineries and warehouses from 6 pm tonight.

I also propose to increase most rates of vehicle excise duty. For the motorist the increase will be £10, from £70 to £80. Duty levels on most other groups of vehicles will be increased by about 12%.

I propose to make two important changes in the VED on commercial vehicles, I have decided that it would offer a substantial, and justifiable, help to small and medium sized businesses at this time to bring the duties on about half a million light commercial vans more closely into line with those on cars.

On the other hand, it would be appropriate, in the light of the conclusions of the Armitage Report, to impose on the heavier lorries – the 80,000 or so of more than 9 tons unladen weight – a licence duty which more closely reflects the actual cost which they impose on the road network.

So the duty on this category will be increased by about a quarter. These changes have effect for licences taken out after today.

The changes I propose for commercial vehicles reflect the Government's intention to get a fairer balance between the taxation burden on different groups of lorries and their road costs. I propose to take a further step in this direction by including in the Finance Bill provisions for restructuring the basis of VED on heavy lorries, to a gross weight method of assessment, and for taxing all light commercial vehicles in due course at the same rate as cars. The House will recall that the framework for this major reform of the VED system was set out in the 1981 Transport Act. It will involve substantial changes in the pattern of commercial vehicle taxation and I think it right that the road transport industry should have time to adjust. I therefore propose that the rates of duty on the new gross-weight basis should take effect from October 1.

And, last of the excise duties, taxes on betting and gaming. Many of my Hon. Friends pressed last year for substantial increases here; and I made some changes in July. I now propose no further increase in the rates of duty on general betting and bingo, both of which were increased then.

But I have decided that pool betting duty, which has been unchanged since 1974, should go up from 40% to 42½% from 1 April. I also propose increases from the same date in the rates of duty on casinos, where I believe the existing rates are too low. Full details of the new rates, and other changes which I shall be announcing today, will be given in press notices this afternoon.

My rt. hon. friend, the Chief Secretary, announced last summer that Customs and Excise would undertake a comprehensive review of gaming machine taxation. A very large number of representations were received during the course of this review, from and on behalf of clubs, public houses, amusement arcades, and others. In the light of these representations I have decided that it would not be appropriate to introduce an ad valorem duty on gaming machines, or to impose an excise duty on amusement machines, such as Space Invaders. I have also decided that duty should no longer be charged on 2p gaming machines which are mostly to be found in the seaside arcades.

However, I have decided that there should be significant increases from October 1 in most rates of the existing licence duty on 5p and 10p gaming machines.

The total effect of all these changes on excise duties will be to raise an additional £1,150m in 1982-83 and £1,165m in a full year. The impact effect on the RPI will be about three-quarters of 1%. This has been fully taken into account in my forecast of falling inflation in the year ahead.

OIL FIELDS

I have spoken of the oil duties: I now turn to the oil-fields. The development of the North Sea has been a story of enterprise and success, which is almost entirely due to the skill and enterprise displayed, and risks accepted, by the private sector. As a nation, we must never forget the great debt we owe to those on the oil rigs and elsewhere, who have been responsible for exploration and development. It is important for them as well as for the British people that the rewards should be fairly shared.

Last year, in the light of the massive increase in oil prices which had occurred in earlier years, we changed the structure of North Sea tax, to make it more responsive to changes in price. At the same time tax revenue from the North Sea was brought forward, with an increase in the total level of taxation. I also invited the industry to suggest better ways of raising the revenue we needed. I am grateful to them, and others who have commented, for their careful and considered response.

As I have mentioned, the current fall in oil prices reduced the revenue the Exchequer receives. I recognise that it reduces the revenues of the oil companies as well – but it also reduces the tax they have to pay.

Detailed study has convinced me that, subject to some marginal adjustment, the total tax burden is not such as to discourage exploration or development. Nor is it so high as to deprive the oil industry of a reasonable and often attractive yield.

In these circumstances I cannot reduce the overall tax burden to the extent that the industry would have wished. But I do agree with them on the need for some change of structure.

ABOLITION OF SUPPLEMENTARY PETROLEUM DUTY

I see, in particular, the advantage of profit-related taxes in relation to additional investment in existing fields. The Supplementary Petroleum Duty will therefore be abolished with effect from the end of this calendar year.

INCREASE OF PETROLEUM REVENUE TAX

I propose at the same time that the rate of Petroleum Revenue Tax should be increased from 70% to 75%; and that arrangements should be introduced for advancing PRT payments. Advance payments of PRT, although computed in the same way as SPD, will not be a separate tax but simply an acceleration of the existing tax.

They will thus differ fundamentally from SPD in being fully set off without limit against ordinary PRT liabilities when these arise. This structural change is one which representatives of the industry have proposed.

As from mid-1983, there will also be a monthly instalment system of payment of PRT in order to secure a smoother public sector cash flow.

These changes will not affect the revenue yield of rather over £6bn in the coming year. But in 1983-84 there will be a net cost, after allowing for the saving in interest due to the new system of instalment payments, of some £70m.

I have spoken earlier about current uncertainties in relation to oil prices and the future yield of tax from the North Sea. But I am aware of the concern felt by the industry about the number of changes in the regime there have been in recent years.

For this reason, my hope is that the new tax structure I have proposed will provide a more secure and stable regime for the future, permitting development to go ahead, uninhibited by major fiscal uncertainties.

I propose a number of other minor changes partly in response to the views put forward by the industry. And I propose that regional development grants paid in respect of expenditure incurred after Budget Day should be taken into account for the purposes of PRT and ring fence Corporation Tax.

We shall also need to legislate next year to deal with certain special problems affecting PRT expenditure reliefs, pipeline tariffs, and other non-oil receipts: these will be the subject of a consultation document which will be issued shortly.

These fiscal measures, combined with the decisions we have already announced on the abolition of the state's sole right to buy gas, and on the creation of the new private sector oil company, will provide a sound basis for another decade of successful enterprise in the North Sea.

MICROELECTRONICS

I turn now to the continuing effort to encourage innovation in industry. If we are to win still more worthwhile orders both at home and abroad British industry must continue to improve its design and production techniques.

There is no more important area to which this applies than microelectronics and information technology. The Government have already given a lead by designating 1982 as Information Technology Year. We have already authorised investment of well over £2bn in the British Telecommunications network in the coming year – more in real terms than at any time since 1974-75. This investment will breed new services, new firms and new jobs. So will the development of alternative and competing services for electronic communication such as the new Mercury network for business.

Because new technology is important on a wider front, I propose to make a further allocation for this purpose. My Rt. Hon. Friend, the Secretary of State for Industry, will shortly be announcing a series of new and expanded schemes. These will include additional assistance towards space technology, and production engineering – including the introduction of a special scheme of assistance to small engineering firms.

And the 100% first-year allowances for leased television sets, which were due to be phased out this June, will be extended for a further year for sets incorporating a teletext facility. This will encourage the wider use of a leading product of British Information Technology.

FISCAL JUSTICE

These measures will be worth £130m over three years.

I have now virtually completed my review of proposals involving spending, and spending foregone. I have described my decisions on excise duties, and the major cut in National Insurance Surcharge which we propose. In the remainder of my speech I shall be dealing primarily with fiscal issues.

I wish to deal first, and briefly, with the key issue of fiscal justice. All Chancellors of the Exchequer come under pressure every year to remedy hardships and anomalies in the tax system. This year has been no exception, and by the end of this afternoon I shall have been able to meet a large number of such points.

But there is another side to this medal. Justice is indivisible. Justice to the taxpayer must be matched by justice to the Exchequer. The revenue must be protected and maintained if the burden is not to fall more heavily on the general body of taxpayers.

We must all be glad to see the courts adopting a new approach towards artificial avoidance schemes. As a direct result, we expect to collect a very large sum of tax, possibly as much as £400m, which might otherwise have been avoided.

TAX EVASION

The proper vigilance of the Revenue Departments in these matters needs to be matched by the determination of Parliament to legislate where this is needed. Last year I asked Parliament to do so on a number of important matters. This year I propose further action.

We must, however, tread a very careful path between safeguarding the interest of the taxpaying community on the one hand and avoiding economic damage on the other.

This need for caution applies, for example, to the proposals affecting the tax liability of companies engaged in international business, on which the Inland Revenue put out consultative papers last year.

COMPANY RESIDENCE

These papers and the draft clauses dealing with these matters have caused considerable anxiety. In the case of company residence the primary objective was simply to replace the present ill-defined rules with ones which were clearer and more certain. This was not an attempt to extend the coverage of the tax. But I accept that some people might be adversely affected. The matter therefore needs to be looked at again.

TAX HAVENS

The problem of tax havens was a different one. If one has an open world in which there is free movement of capital and of persons – something which in itself is a good thing – this offers increased opportunities for tax avoidance. We must be very careful not to prejudice legitimate business, particularly because of the importance of London as a financial centre. We need to find the right middle road, and one which is accepted as right. It is to this end we shall be directing our efforts. Clearly this precludes legislation this year on any of these topics.

INTERNATIONAL LEASING

I now turn to the areas in which I do propose to take action in this Finance Bill.

First, international leasing. At present, assets leased abroad attract capital allowances at what is, in many cases, a favourable rate of 25% per annum. Leasing of this kind has grown sharply.

Moreover, there is evidence of U.K. tax incentives being used to subsidise deals between other countries – deals by foreign businesses in foreign-made goods, competing with our own home producers. I therefore propose, for new commitments after today, to reduce from 25% to 10% the rate of writing-down allowance for all assets leased abroad.

FILMS

Second, films. Investment in films qualifies for 100% first year allowances. As with other capital provisions, these investment incentives are available without regard to whether the film is made in this country or overseas.

There is evidence that schemes for investment of this kind – primarily in foreign-produced films – are currently being marketed actively in this country. The potential loss to the revenue is very great.

I propose, therefore, to withdraw the 100% first year allowance for films and to introduce in its place a provision which will, in broad terms, allow companies to write off expenditure over the income-producing life of the film.

A change of this kind could have serious implications for the British film industry, if introduced immediately, at a time when there are signs that it is just beginning to establish a new and more competitive position.

I intend therefore to introduce transitional relief for British-made films – broadly speaking, films registered for the purposes of the Eady levy arrangements – for a two-year period. I shall be consulting the industry about the form which this assistance might take.

SHIPPING

Third, shipping. Here again, arrangements are being made to exploit U.K. investment incentives for the benefit of foreign businesses. In this case, a typical arrangement may involve a foreign shipping company chartering a vessel built abroad from a company specially set up in the U.K. to attract 100% capital allowances. I propose to reduce the rate of capital allowance in these cases to the 10% rate for international leasing generally. I am concerned to safeguard the position of British companies chartering their vessels abroad in the course of a genuine shipping business, and I shall be discussing with the shipping industry how best to do this.

On each of these three subjects – international leasing, films, shipping – the changes will take effect from today. I shall be bringing forward the necessary detailed legislation at Committee Stage.

LOANS

Fourth, so-called Section 233 loans. These are contrived arrangements under which interest paid on certain bank loans escapes liability to corporation tax in the hands of the banks. In future these payments will be taxed like other interest payments. The new rules will apply from today. In the case of contracts entered into before today, the new rules will apply to payments due on or after 1 April 1983.

DOUBLE TAX RELIEF AND BANKS

Fifth, by taking advantage of double tax relief banks can lend overseas at abnormally low interest rates at the expense of the U.K. taxpayer.

I propose to include in the coming Finance Bill measures to stop this exploitation of our tax system. They will take effect from 1 April 1982 but in the case of existing loans will apply only to interest arising from 1 April 1983.

While the measures I have announced will help, we shall need to give much further thought in the coming year to the problem of how best to ensure a sufficient contribution to tax revenues from the banking sector. The problem is not an easy one, as the benefit of some of the devices I have just described is shared between the banks and their domestic customers. There is a danger that measures directed to ensuring that the banks pay a more equitable amount of tax are all too simply bypassed by the banks shifting the burden on to their customers. For these reasons I have forborne from taking action earlier, but as Burke said, "There is however a limit at which forbearance ceases to be a virtue."

BUILDING SOCIETIES

On a different note, a number of building societies have recently issued a new form of negotiable bond. I have no reason to believe that any improper use has been made of these new bonds. But as an obvious precaution, I propose to extend to these bonds, from today, the existing provisions dealing with the "manufacture of dividends."

GOLDEN HANDSHAKES

I also propose some tighten-up of the law relating to very large golden handshakes. The tax relief will be withdrawn on a sliding scale with the effect that the excess of sums over £75,000 will be fully charged to tax.

We owe it to the ordinary taxpayer to take action in these fields. It is on him that the cost would fall if we did not do so.

HELP FOR BUSINESS AND INDUSTRY

I now revert to my principal theme: help for business and industry, and hence for jobs and people. Last year's Budget contained a number of measures to help the construction industry, an industry which can make a particularly significant contribution to the creation of new jobs. It is, accordingly, right to give it further help this year.

HOUSING

As I have already mentioned, our new public spending plans provide work for the construction industry in 1982-83 worth about £10¼bn – an increase of 14%.

This year local authorities have greatly underestimated the success of our policy of selling council houses and land. The extra revenue which this is bringing in has not been spent. For 1982-83, they have been assured that they can spend up to a total of some £3bn on housing.

This will include about £1bn of funds which they can expect to receive mainly as a result of the success of the right-to-buy legislation. This should allow an increase of nearly one third in the scale of their capital spending, compared with what they seem likely to spend in 1981-82.

In addition I now propose a charge for 1982-83, designed to help private home-owners whose houses fall well short of today's standards.

The value of grants given for major repairs, and for the provision of basic amenities in the home, under the Home Improvement Grant System, will be increased for a limited period, to a maximum 90% of the eligible cost, instead of the 75% currently available.

This increased rate of grant will apply only to applications received before the end of 1982. The purpose is not to add to longer term demands on the industry but to encourage the take-up of immediate spare capacity. We also intend both to enable more people to get grants for home insulation and to increase the value of these grants.

To pay for these changes and to encourage local authorities to make more general improvement grants available, their capital allocations in 1982-83 will be increased by £100m. This will be over and above the expenditure provided for in the White Paper.

My Rt. Hon. Friend, the Secretary of State for the Environment, has already announced measures for 1982-83 to give priority to inner city projects that offer the greatest degree of participation by the private sector.

Building on this, up to £70m of the provision for the Urban Programme and for Derelict Land reclamation in 1983-84 will be earmarked for projects that encourage participation by the private sector.

DERELICT LAND

We have also decided to offer further encouragement to the private sector and nationalised industries to bring derelict land into productive use; we shall increase the grant payable from 50% of the cost of reclamation to 80%, in Assisted Areas and Derelict Land Clearance Areas when legislation can be brought forward. The cost will be contained within the existing programme.

In addition, we shall give further encouragement to new private investment in housing for rent. I now propose to introduce capital allowances, at the rate of 75% for the first year only, for expenditure on the construction of properties wholly for letting as assured tenancies by bodies approved by the Secretary of State. The scheme will run for an experimental period of five years. Allowances may be claimed for expenditure incurred as from today.

In my Budget two years ago, I introduced the small industrial workshop scheme, under which industrial buildings allowance can be claimed on the construction of small buildings at the rate of 100%. The scheme has been a resounding success.

SMALL BUSINESSES

Over 5,000 new workshops have already been constructed for letting to small businesses, at an estimated Exchequer cost spread over several years, of £125-£150 million.

The scheme has succeeded in increasing the stock of industrial workshops at or near the upper size limit. But there has been relatively little investment at the very small end of the range. I therefore propose to extend the scheme for very small workshops, of not more than 1,250 square feet, for a further two years, until March 1985.

I also propose to bring within the scope of the industrial buildings allowance certain kinds of servicing, repairing and warehousing activities. This too will improve the small workshop scheme.

I also propose to deal with the liability to VAT of certain kinds of building alterations, where there has in the past been serious doubt about what was liable to charge. A recent judgment of the House of Lords would have led, if applied in its entirety, to VAT being charged at the standard rate on a range of non-structural building alterations which had previously been free of charge. Though clarifying the law, this judgment would have imposed an extra £80 million of tax on the industry, which it can ill afford at present.

So I intend to re-establish the clarity needed, but in a way which will relieve the industry of all but £10m of the extra tax burden. I shall, in due course, lay before the House an Order, which will have the effect of continuing to zero-rate three important kinds of alterations which might otherwise be adversely affected by the House of Lords' judgement.

These are the most commonly recognised forms of double glazing, loft and cavity wall insulation and damp-proof coursing. This useful simplification of the law will cost the revenue about £70m a year.

The other kinds of non-structural alteration covered by the judgement will become subject to VAT but, pending the completion of discussions with the industry, no steps will be taken to apply the tax before about the beginning of September.

My final proposal in this area concerns Stamp Duty on house purchase. I propose to raise the exemption by £5,000, to £25,000, and the other thresholds also by £5,000, at a total cost of £70m in 1982-83.

This change should be widely welcomed. It will help to improve job mobility and give some encouragement to house construction. But most of all it will help those who have been saving to buy their first homes. By the end of this Parliament, nearly three out of five families will own their own homes. This will represent a significant extension of the property-owning democracy.

And, taken together, these proposals will mean more work for the construction industry, and more jobs for those who work in it.

Evident in the measures I have announced so far is the Government's consistent determination to help create the right conditions for the new investment needed to create new jobs. But this Budget, like its two predecessors, is designed also to provide a special tonic for small businesses.

BUSINESS START-UP SCHEME

There can be no doubt that higher rates of interest and the consequent reluctance of companies to borrow long-term at high fixed rates have caused a distortion of balance sheets. Too much reliance is now placed on short-term bank finance. As a result there is additional pressure on monetary growth.

A number of suggestions have been made for reducing the burden of interest rates on companies. We are all indebted to my hon. friend, the member for North-West Surrey, and others, for the way in which they have focused public attention on this problem. In many cases, the selectivity in the remedies proposed would favour lending by the banks and lending to "tax-exhausted" companies. We have considered these ideas very carefully. But they raise difficult questions of principle, and we are not persuaded that they offer the best solutions to the problems they are designated to solve. Moreover, consultations are still not complete on the Corporation Tax Green Paper, which raises major questions about incentives to investment, and we are still considering how best to ensure a proper contribution to tax revenues by the banking sector.

However, we can all agree that the basic problem of financing profitable expansion and investment demands urgent and continuing attention. A particularly important aspect of this is the provision of equity capital, about which I have some new proposals to make.

The Business Start-Up Scheme, which provides income tax relief for investments of up to £10,000 in the equity of companies starting new trades, has been widely welcomed. I propose for 1982-83 and 1983-84 to increase the annual limit from £10,000 to £20,000. As less than a full year has elapsed since it became law, some potential investors may have been unable to use up the full £10,000 limit in 1981-82.

I therefore propose that, in addition, any unused balance of this year's limit should be added to next year's. This means that, in some cases, the effective limit for 1982-83 will be as much as £30,000. These improvements should provide a further stimulus to investment in new enterprises.

Where capital for small businesses generally is concerned, many people have emphasised the importance of the new provisions introduced in the 1981 Companies Act for companies purchasing their own shares. Clearly, it would be wrong to change the tax law in such a way that these provisions could be used to pay out what would amount to tax-free dividends. But there is scope for tax changes which will significantly increase the attractions of equity capital, both to the investor and to the entrepreneur.

I now propose that certain purchases of their own shares by unquoted trading companies, mainly small and family businesses, should not be subject to ACT and income tax. They will be treated instead as sales of shares by the shareholder, and therefore, subject in most cases to Capital Gains Tax only. This measure will be of special benefit to small companies which have a limited market for their shares.

EMPLOYEE PARTICIPATION

Two years ago, I relaxed the conditions governing profit-sharing schemes and reintroduced legislation enabling employees to take up options to buy shares in their companies without incurring income tax liability.

I did this because I have no doubt that employees who own shares in the company for which they work develop a greater sense of commitment to the success of the business. Since I made my first changes two years ago, the increase in the numbers of employee share schemes has been extremely encouraging. In 1979 there were only 30 such schemes. Now there are over 400.

This is exactly as we should wish. Wider share-ownership is good for the business, good for the worker and good for Britain.

It is important to maintain and extend this progress. Accordingly, I now propose to increase the value of shares that can be allocated each year to any one employee from £1,000 to £1,250. I also propose to amend the detailed rules to help simplify the administrative problems arising on rights issues. We should also give some help and incentive to those who acquire share options outside the ambit of approved schemes. I therefore propose to make it easier for them to pay the income tax chargeable on the exercise of such an option by providing that it should be collected over three years rather than in a single sum.

In the last two years we have substantially relaxed the rules for tax relief for interest on money borrowed to invest in small companies. This year I propose to move a stage further. If a shareholder works full-time in the management of a business he will in future be able to qualify for tax relief to invest in that business even though he does not have more than 5% of the shares.

PILOT LOAN GUARANTEE SYSTEM

Now, loan finance. In my last Budget I announced the establishment of a pilot loan guarantee scheme. The scheme started in June 1981. Since then the demand for loans has far exceeded expectations.

Last October, in response to that demand, we increased the allocation for the first year from £50 million to £100 million; but with 2,700 loans worth almost £100 million already approved after only nine months, some further increase is desirable. Accordingly, I propose to increase the amount which the participating institutions may lend to £150 million for the first year. In addition a further £140 million will be available for loans under the scheme during its second year, to June 1983.

CORPORATION TAX RATE FOR SMALL COMPANIES

I also propose that the limits for the "small companies" rate of corporation tax should go up again from £80,000 to £90,000, and from £200,000 to £225,000. This will mean that this Government has increased the lower limit by 80% and the upper limit by more than 150%.

PRE-TRADING RELIEF

As a further help for new businesses, the period for income and corporation tax relief for pre-trading expenditure will be extended from one to three years.

ENTERPRISE AGENCIES

Many hon. members, I know, have been impressed by the value of the work done by local enterprise agencies. These agencies depend in the main on businesses already established in the local community. They clearly play a valuable part in helping small local firms to start and to prosper.

I therefore propose to allow businesses to deduct for tax purposes the contributions they make to certain enterprise agencies, which concentrate on helping small firms. I hope this measure will encourage more widespread support for such agencies. The relief will be available from March 31 and will run for 10 years.

VAT

On VAT, I have two principal changes to propose. The registration threshold will be increased from £ 15,000 to £ 17,000. And I propose to introduce VAT relief for services supplied before registration. This measure, and the extension of relief for pre-trading expenditure, will reduce the costs of starting a new business.

The total revenue cost of these measures to help small firms is about £ 80m in a full year.

I also want to make it easier for those who have recently left school or college to start a business. Hitherto they have not been able to qualify for the socalled 714 certificates under the construction industry tax deduction scheme. The present system, designed to prevent tax evasion, may actually keep young people out of work as sub-contractors in the industry. The certificates are widely used in the industry but the existing rules require an individual to show that he already has three years good record as a taxpayer before he can secure a certificate.

By definition, someone who has just left school or college cannot qualify under this three-year rule. I now propose to change it, so as to enable school and college leavers to obtain special certificates. I also propose a guarantee scheme which may help others to obtain these special certificates.

PENSION RELIEF

Finally, the self-employed. A decade of inflation has eaten into the value of money which they had put aside to provide for their retirement. I therefore propose to increse the limits on retirement annuity relief for contributors who are now in their 50s and 60s - to 20% for those born between 1916 and 1933, to 21% for those born in 1914 or 1915, and to 24% for those born in 1912 or 1913. I also propose to alter the present restricions on the relief to allow more self-employed people to benefit from these higher levels. These changes will cost £ 12 million in 1982-83 an £ 25 million in a full year. They will provide a significant improvement in the position of the older contributor whose lifetime savings have suffered particularly from high rates of inflation in the 1970s.

The self-employed play a key role in the economy. Their contribution to its vitality, its adaptability, is apparent to all. A long with small businessmen, they fully merit this extra encouragement.

CAPITAL TRANSFER TAX

I turn now to a part of our tax system which is impeding the efficient working of capital markets and doing injustice to individuals and businesses alike: the capital taxes.

There is room for wide differences of view about the principle of taxing capital. But there is no case whatever for maintaining a system of capital taxes which, by holding back business success and penalising personal endeavour, does serious economic and social damage.

In each of the last two budgets, we have taken significant steps to reduce such damage. I propose carrying this process a stage further today.

The threshold for Capital Transfer Tax will now be increased to £ 55,000. The rate bands which apply above the thresholds have remained virtually unaltered since the tax was introduced in 1975. It is time they were extended. Under the new scale, details of which will appear in the FSBR, the top rate of tax will be reached at £ 2.5m.

In real terms, this is still not as high as the figure set by my predecessor, when he introduced the tax, in 1975. The lifetime scale will be improved to a similar extent. The cost this year will be £ 35m: and in a full year £ 85m.

I also propose that the indexation principles, already applied to income tax allowances, should in future apply as well to the CTT threshold and bands.

I should add that it is my intention that the Finance Bill should deal with the new regime for settled property. Draft clauses were published in December. The comments we have received will help us to clarify and improve the provisions. They have more than justified this exercise in open Government. I am grateful to all those who have contributed. There will also be a number of technical provisions related to the heritage. I have decided, in the light particularly of the reductions in the lifetime rates of charge I made last year, not to alter the rate at which the periodic charge is payable.

I also propose that foreign currency accounts belonging to individuals who have no connection with the U.K. should not be caught by the CTT. It is important for London's position as the world's leading financial centre that this matter should be cleared up.

CAPITAL GAINS AND INFLATION

I now come to the incidence of Capital Gains Tax on inflationary gains. This is a matter which has rightly given rise to a great deal of discontent. No-one has yet succeeded in finding a solution to this problem.

Innumerable proposals for full indexation, for tapering and other ingenious devices have been put forward. None, unfortunately, overcame all the practical difficulties. I cannot, however, allow this injustice to continue. It is intolerable for people to be permanently condemned to pay tax on gains that are apparent but not real – that exist only on paper.

I propose, therefore, that, as from this April, gains, including those of companies, will, in principle, be calculated after taking account of inflation which occurs after that date. No relief will, however, be given in respect of the first year of ownership. The problem we seek to solve is one which relates essentially to assets held for a period of years, and it would not be appropriate to extend relief to assets bought and sold within a comparatively short period of time.

Because we have not found it possible to extend the new scheme to cover past gains, I propose also that the exempt slice should be increased to £ 5,000. That is the best solution to the problem of the past and will simplify administration both for the taxpayer and the Revenue. For the future, I intend that this threshold too should be statutorily indexed.

There will be no revenue cost in the coming year. In 1983-84 the cost of these two measures will be £ 55m.

But this ought not to be looked at as a measure of the cost to the Exchequer. It is rather a measure of the tax which ought never to have been levied in the first place. This change is no more than simple justice, which should be welcomed on all sides of the House.

The benefit of these measures will be of substantial help to business as well as the individual. They will significantly increase the attraction of equities to U.K. taxpayers. One result should be that companies can raise more equity at lower cost than would previously have been possible. An increase in the scale of equity issues by companies will help to reduce their dependence on bank borrowing.

ROLLOVER RELIEF

I also propose a number of other specific changes: in future, rollover relief will be available on compulsory purchase; and, completing our policy of avoiding a double charge of CGT and CTT on the one event, rollover relief will also be available on assets coming out of trust. These proposals invoice no cost this coming year and a cost of £ 11m in 1983-84.

I believe that these changes, taken together, will be widely welcomed as a further major reform of the capital taxes.

REDUCTION OF THE PERSONAL INCOME TAX

But for the vast majority of individuals what really matters is income tax. And income tax is far and away the biggest source of Government revenue. This year about 26m income taxpayers wil contribute, in round figures about £ 30m to the Exchequer.

Quite rightly people look for some reduction in their own tax burden. As I have explained at the outset, and demonstrated by my proposals, the paramount aim of this Budget is to help industry, to encourage business, to create jobs.

But I want also to assist people directly. The one helps the other. People need industry but industry also needs people - as workers, as customers, as investors. We remain firmly committed as ever, over the years, to reduce the burden of direct taxation. It is essential to do so: to improve incentives: to remove disincentives: te reduce the poverty trap.

There are always, of course, competing arguments as to whether one should reduce the rates of income tax or raise the thresholds at which people pay tax. Any Chancellor would like to be able to do both. But this year, given my principal aim, I have had to make a choice.

We have already reduced the basic rate of tax from 33% to 30%, and reduced the higher rates of tax as well. I propose, therefore, to concentrate the relief that is available this year on raising the tax thresholds.

The single personal allowance will accordingly be increased by £ 190 to £ 1,565 and the married allowance by £ 300 to £ 2,445.

The additional allowance for single parents will, as a consequence, rise by £ 110 to £ 880. So too will the widow's bereavement allowance. And there will be corresponding increases in the age allowances, the higher rate threshold and bands, and the threshold for the Investment Income Surcharge. Effect will be given to changes under PAYE as from the first pay day after 26 April.

These increases are up to 2% points *more* than the 12% required to take account of inflation in 1981. They are worth £ 1.8bn this year and almost £ 2½bn in a full year. As a result some 1.2m people who would have paid tax next year will not now have to do so. This news will be very welcome both to the House and to the country at large.

In framing this year's Budget, Mr. Speaker, it has been my purpose to give as much encouragement as I believe we can afford to an economy which is now moving in the right direction.

To hearken to the voices that urge us only to "borrow, borrow, borrow" would perform no service to British industry or to the unemployed. On the contrary, it would lead only to the dead end of a plummeting exchange rate or a rocketing rate of interest - most probably to both.

Better by far to secure, as I have done, a prospective level of borrowing that is below that of the year now ending and so to maintain our progress towards stables prices.

And at the same time, as in each of my three earlier Budgets, to achieve substantial tax reforms, to promote the wider ownership of wealth, and to encourage the productive private sector, which in these past three years has made giant strides towards the restoration of our reputation as a trading nation.

This is a Budget that will give confidence at home that growing markets will be there for those prepared to go out and win them. And so a better prospect of employment opportunities for those who look only for the chance to work.

And confidence abroad that Britain stays on course, to put a dismal record of performance behind us once and for all.

This Budget is designed to give that double boost to confidence. I commend it to the House and to the nation.

THE FINANCIAL STATEMENT

INCOME TAX

It is proposed: to increase the single person's allowance and the maximum wife's earned income relief from £ 1,375 to £ 1,565 and the married allowance from £ 2,145 to £ 2,445.
– to increase the additional personal allowance and widow's bereavement allowance from £ 770 to £ 880.
– to increase the age allowance for the single person from £ 1,820 to £ 2,070, for the married from £ 2,895 to £ 3,295 and the age allowance income limit from £ 5,900 to £ 6,700.
– to increase the basic rate limit to £ 12,800.
– to increase the width of the 40% band to £ 2,300, the 45% band to £ 4,000 and the widths of the 50% and 55% bands to £ 6,200.
It is proposed: to raise the threshold for the investment income surchage for 1982-83 from £ 5,500 to £ 6,250.
– to revise the system of reliefs available to individuals receiving payments above £ 25,000 on termination of employment.
– to exempt mobility allowance from tax.
– to raise from £ 1,000 to £ 1,250 the maximum annual value for appropriations of shares to an employee under an approved profit sharing scheme.
– to alter the basis for the exemption limit for capital receipts arising from shares held under approved profit sharing schemes.
– to allow the income tax payable on the exercise of a share option by a director or employee to be paid by instalments over three years.
– with effect from 1983-84, to change the arrangements for giving mortgage interest relief.
– to increase the percentage limit on retirement annuity relief from 17½% to 20% for individuals born between 1916 and 1933, from 20½% to 21% for those born in 1914 or 1915 and from 23½% to 24% for those born in 1912 or 1913, and to remove the existing ban on the provision of these higher rates of relief for individuals with pensions or pension rights under sponsored superannuation schemes in respect of any previous full-time employment.
– to extend relief for interest paid on money borrowed for investment in a close company to borrowers who own 5% or less of its ordinary share capital, provided that they act for the greater part of their time in the management or conduct of the business.
– in respect of the relief for investment by outsiders in certain new corporate trades ("Business Start-up Scheme") to increase the limit for each of 1982-83 and 1983-84 by £ 10,000 and for 1982-83 by any unused balance of the limit for 1981-82.

INCOME TAX AND CORPORATION TAX

It is proposed: to extend the definition of an industrial building for industrial buildings allowance purposes to include buildings used for certain repairing and servicing activities.
– to extend the small industrial workshop scheme for a further 2 years, for industrial buildings not exceeding 1,250 sq ft.
– to allow relief for contributions to certain enterprise agencies.
– to extend, for one year, the 100% first year allowance for expenditure on rented television sets incorporating a teletext facility.
– to introduce a first year capital allowance, at the rate of 75%, for expenditure in the construction of certain buildings for letting as private residential accommodation, under the assured tenancies scheme.
– to extend the relief for pretrading expenditure.
– to exempt dealers in Eurobonds from the provisions designed to prevent loss of tax through bond-washing.
– to bring certain securities issued by building societies within the provisions designed to prevent loss of tax through the manufacturing of interest.

INCOME TAX, CORPORATION AND CAPITAL GAINS TAX

It is proposed in appropriate cases to change the tax treatment of distributions made by companies in purchasing their own shares.

CORPORATION TAX

It is proposed: for the financial year 1981 to increase the limit for the "small companies" rate of corporation tax from £ 80,000 to £ 90,000 and the limit for marginal relief from £ 200,000 to £ 225,000.
– to amend the definition of "distribution" as it affects borrowing in the form of "equity loans".

CORPORATION TAX AND CAPITAL GAINS TAX

It is proposed: to adjust expenditure allowable in calculating gains on disposals having regard to future increases in the retail prices index.
– to increase the level of exemption for gains on chattels.
– to introduce a rollover relief for compensation paid on compulsory purchase.

OIL TAXATION

It is proposed: to extend Supplementary Petroleum Duty (SPD) for the chargeable period ending on 31 December 1982, only.
– to increase the rate of Petroleum Revenue Tax (PRT) from 70 to 75% for chargeable periods ending after 31 December 1982, and to spread its collection in monthly instalments after 30 June 1983.
– to introducing a system of advance payments of PRT for chargeable periods ending after 31 December 1982, at a rate of 20% of gross profits less an oil allowance of ½m tonnes per chargeable period, the advance payments to be set off against current or later liability to PRT or, failing set-off, repaid at the end of field life.

– to amend the point of charge for PRT an SPD for certain arm's-length sales of gas and to provide alternative rules for determining the market value of ethane used for petrochemical purposes.
– to allow Corporation Tax relief for certain losses and charges outside the oil production "ring fence".
– to disallow for the purposes of PRT and ring fence Corporation Tax expenditure incurred after Budget day to the extent that it is met by Regional Development Grants.

CAPITAL GAINS TAX

It is proposed: to increase the threshold from 1982-83 so as to exempt individuals on the first £ 5,000 of capital gains in a year and most trusts on the first £ 2,500.
– to require for the future an annual revision of the thresholds for individuals and trusts in the light of changes in the retail prices index.
– to extend the rollover relief for lifetime gifts to transfers out of settlement.
– to revise the rules for gains arising on the termination of a life interest in settled property.

CAPITAL TRANSFER TAX

It is proposed: to introduce new rate schedules for both death and lifetime transfers as follows:

Band of chargeable value £ '000	*Rate on death %*	*Lifetime rate %*
0 - 55	Nil	Nil
55 - 75	30	15
75 - 100	35	17½
100 - 130	40	20
135 - 165	45	22½
165 - 200	50	25
200 - 250	55	30
250 - 650	60	35
650 - 1,250	65	40
1,250 - 2,500	70	45
Over 2,500	75	50

It is proposed: to require for the future an annual revision of the rate bands in the light of changes in the retail prices index.
– to increase the exemption limits for transfers within one year of death to charities to £ 250,000 and for transfers to non-domiciled spouses to £ 55,000.
– to restructure the charge to tax on discretionary trusts.
– to exempt from the charge on death non-sterling bank accounts of depositors who are not domiciled, resident or ordinarily resident in the United Kingdom at the time of their death.

CAPITAL TRANSFER TAX AND INCOME TAX

It is proposed: to alter the conditions on which the Treasury may designate trusts as maintenance funds for heritage purposes and to amend the charges to tax which may arise following the setting up of these funds.

VALUE ADDED TAX

It is proposed to amend Section 20(1) and Schedule 1 to the Finance Act 1972 so as to increase the registration and deregistration limits. From 10 March 1982 the registration limits will become £ 17,000 per annum and £ 6,000 per quarter. From 1 June 1982 the deregistration limits will become £ 16,000 per annum where estimated future turnover is concerned, and £ 17,000 per annum where past turnover is concerned.
It is proposed to amend paragraph 11 of Schedule 1 to the Finance Act 1972 in order to restrict the Commissioners' powers to grant discretionary registration to certain traders.
It is proposed to apply, by Order, the zero-rate of VAT to supplies of building alterations by way of the most commonly recognised kinds of double glazing, loft and cavity-wall insulation, and damp-proof coursing.

ALCOHOLIC DRINKS

It is proposed from midnight 9-10 March 1982, to increase:
(a) the rates of duty on spirits from £ 13.60 (for mature spirits) and £ 13.63 (for immature spirits) to a uniform rate of £ 14.47 per litre of alcohol in the spirits;
(b) the rate of duty on beer from £ 18.00 to £ 20.40 per hectolitre and the charge for each additional degree of original gravity above 1030 degrees per hectolitre from £ 0.60 to £ 0.68;
(c) the rates of duty on wine by the following amounts per hectolitre:
Wine of an alcoholic strength:
– not exceeding 15%: from £ 95.20 to £ 106.80.
– exceeding 15% but not exceeding 18%: from £ 122.90 to £ 137.90.
– exceeding 18% but not exceeding 22%: from £ 144.70 to £ 162.30.
– exceeding 22%: £ 162.30 plus £ 14.47 (instead of £ 13.60) for every 1%, or part of 1%, in excess of 22%;
– surcharge on sparkling wine: from £ 20.90 to £ 23.45;
(d) the rates of duty on made-wine by the following amounts per hectolitre:
Made-wine of an alcoholic strength:
– not exceeding 10%: from £ 61.80 to £ 73.10.
– exceeding 10% but not exceeding 15%: from £ 92.50 to £ 103.80.
– exceeding 15% but not exceeding 18%: from £ 113.90 to £ 127.80.
– exceeding 18%: £ 127.80 plus £ 14.47 (instead of £ 13.60) for every 1%, or part of 1%, in excess of 18%;
– surcharge on sparkling made-wine: from £ 9.60 to £ 10.75;
(e) the rate of duty on cider and perry from £ 7.20 to £ 8.16 per hectolitre.

STAMP DUTIES

It is proposed: to raise with effect from 22 March 1982 the level below which transfers of property (other than stocks and shares) are not liable to stamp duty from £ 20,000 to £ 25,000, to adjust the associated bands of reduced rates of stamp duty correspondingly and to alter certain limits affecting stamp duty on new leases.
– to exempt transfers of assets to charities.

HYDRO CARBON OIL

It is proposed, from 6 pm on 9 March 1982, to alter:
(a) the rate of duty on light hydrocarbon oil (other than aviation gasoline), petrol substitutes and spirits used for power methylated spirits from 13.82p to 15.54 per litre;
(b) the rate of duty on heavy hydrocarbon oil for use as road fuel from 11.91p to 13.25p per litre;
(c) the rate of duty on aviation gasoline from 13.82p to 7.77p per litre;
(d) the rate of duty on gas for use as road fuel from 6.91p to 7.77p per litre.

TOBACCO

It is proposed, from midnight 11-12 March, to increase:
(a) the specific element in the duty on cigarettes from £ 19.03 to £ 20.68 per 1,000 cigarettes (the ad valorem element remaining unchanged);
(b) the duty on cigars from £ 35.91 to £ 39.00 per kilogram;
(c) the duty on hand-rolling tobacco from £ 30.96 to 33.65 per kilogram;
(d) the duty on other smoking and chewing tobacco from £ 22.96 to £ 24.95 per kilogram.

POOL BETTING DUTY

It is proposed to increase the rate of pool betting duty from 40% to 42½% on events on and after 1 April 1982.

GAMING LICENCE DUTY

It is proposed, from 1 April 1982, to increase the rates of gaming licence duty. The advance payment will remain at £ 250, but the second payment, to be made up to five months after the licensing period, will be a proportion of the gross gaming yield (stakes less winnings) in each six-monthly period as follows:
5% of the first £ 500,000 plus
12½% of the next £ 1,750,000 plus
25% of the remainder of the gross gaming yield.

BINGO DUTY

It is proposed, from 27 September 1982, to restrict the existing exemptions from bingo duty so that al large-scale bingo (where the value of prizes has exceeded £ 300 in any one day or £ 1,000 in any one week) is made liable to duty.

GAMING MACHINE LICENCE DUTY

It is proposed, from 1 October 1982, to abolish the existing duties on all "2p per play" machines and to increase the annual rates of licence duty on other machines as follows:
(a) Premises with local authority approval: from £ 60 for the first machine and £ 120 for subsequent machines to £ 120 for each "5p per play" machine and £ 300 for each "10p per play" machine;
(b) Premises without local authority ap-

proval: from £ 200 to £ 300 for each "5p per play" machine and from £ 400 to £ 750 for each "10p per play" machine.

It is proposed to amend the comparable provisions in the Miscellaneous Transferred Excise Duties Act (Northern Ireland) 1972 so that the abolition of duty on "2p per play" machines and the new rates at
(b) above will also apply in Northern Ireland.

SURCHARGES AND REBATES OF EXCISE DUTIES

It is proposed to amend the Excise Duties (Surcharges or Rebates) Act 1979 to allow surcharges or rebates to be applied to individual rates of the duties to which that Act applies.

It is proposed to increase the excise duty on most mechanically-propelled vehicles chargeable under Section 1 of the Vehicles (Excise) Act 1971 and under Section 1 of the Vehicles (Excise) Act (Northern Ireland) 1972 by about 12%. This figure is broadly descriptive. There will be some variations within particular vehicle categories. The duty on most cars will rise by £ 10 to £ 80. The rates of duty on certain groups of light commercial vehicles will be marginally reduced and a larger selective increase of 25% will be applied to all duty levels on goods vehicles over 9 tons unladen weight. These changes have effect in relation to licences taken out after 9 March.
It is additionally proposed to include provision in the Finance Bill for the restructuring of vehicle excise duty on heavy goods vehicles from an unladen weight to a gross weight basis of assessment and to introduce a new taxation regime for light commercial vehicles. These changes, which were foreshadowed in the 1981 Transport Act, will take effect from 1 October 1982.

NATIONAL INSURANCE SURCHARGE

It is proposed to reduce by 1 percentage point to 2½% the surcharge paid in respect of employees by secondary Class I contributors under the provisions of the National Insurance Surcharge Act 1976. This reduction will take effect from 2 August 1982. It is also proposed to reduce the rate of surcharge payable in respect of earnings between 2 August 1982 and 5 April 1983 by a further ½ percentage point.

Approximate direct effects of changes in duty rates on certain product prices
(All except VED* inclusive of 15% VAT)

Spirits duty	30p on a bottle of spirits
Beer duty	2p on a pint of beer of average strength
Wine duty	10p on a bottle of table wine
Fortified wine duty	13p on a bottle of sherry
Petrol duty	9p on a gallon of petrol
Derv duty	7p on a gallon of derv
Tobacco duty	5p on a packet of 20 cigarettes
Vehicle excise duty	£ 10 on a car licence

* Vehicles excise duty

CANADA: SALES TAX REFORM

Implementation date delayed

The following is the full text of a Finance Department Communiqué dated April 13, 1982:

The Honourable Allan J. MacEachen, Deputy Prime Minister and Minister of Finance, today announced the proposed implementation date for conversion of the manufacturer's sales tax to the wholesale level will be January 1, 1983.

The Minister said the postponement from June 1, 1982 to January 1983 is in response to requests from wholesalers and other members of the business community for more time to study the draft legislation and to prepare for its implementation.

The Minister expects to make the draft legislation available by the end of the month for public study and comment. He added that the January 1, 1983, implementation date is tentative and that he will confirm it later in the summer once he has had time to assess public comments on the draft legislation.

This structural change in the sales tax is intended to correct a bias in the application of the tax that now favours imported goods over competing domestic manufactured goods. It will also deal with other inequities and anomalies resulting from the wide variations in the way goods are marketed. The change follows detailed studies and public consultations over the past seven years.

The Minister emphasized that the shift in tax to the wholesale level will yield no additional revenues to the federal government. Any overall revenue gain from adopting the wholesale price base will be offset by the reduction of the general sales tax rate from 9 to 8%.

For some products the tax rate reduction will not fully offset the effect of changing to a wholesale base for the tax. However, it will mean a direct reduction in tax on a wide range of other products – those that do not flow through wholesalers or that are already subject to tax at the wholesale level. For example, it is estimated that on North American automobiles, which are sold by manufacturers directly to dealers, there will be reductions in the federal sales tax averaging between $100 and $200 per car.

The Minister noted that the reduction in the general tax rate from 9 to 8% will take place six months after the conversion to the new tax base in order to offset a one-time revenue loss resulting from refunds of tax already paid on wholesaler's inventories.

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Belgium

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  release 223

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Conference Diary

MAY 1982

Management Centre Europe: Leasing in the 80's (including: The harmonisation of taxes in the E.E.C. and relevance for leasing). Brussels (Belgium), May 5-7 (English).

Seminar Services International: International Tax Planning (including: Use of tax treaties and tax treaty developments; legislation to counter use of tax havens and U.K. draft legislation on international tax avoidance). Amsterdam (the Netherlands), May 12-13 (English).

AMR International: Subcontracts and joint ventures in the Middle East, the legal and financial issues (including: Taxation and the Subcontractor). London (United Kingdom), May 13-14 (English).

International Tax Planning Association: 8th Annual Conference (including: The U.S. tax haven report; international tax planning for entertainers and athletes; taxes on non-residents; anatomy of a tax haven). Florence (Italy), May 19-21 (English).

Practising Law Institute: Real estate syndications (including: Special problems of foreign investors; The non-resident alien individual partner). San Francisco (U.S.A.), May 20-21 (English).

Management Centre Europe: International cash management (including: International tax aspects in cash management). Nice (France), May 24-26 (English).

The Inter-American Center of Tax Administrators (C.I.A.T.): XVIth General Assembly on the basic subject Non-tax compliance. Asunción (Paraguay), May 24-28 (Spanish, English, French and Portugese).

Institute for International Research: The Zürich International Corporate Finance Conference (including: Legal, accounting and tax issues of different hedging forms; tax leveraging). Zürich (Switzerland), May 24-26 (English).

JUNE 1982

Management Centre Europe: Taxation of international group companies and branches (Seminar). Brussels (Belgium), June 3-4 (English).

Seminar Services International: Taxation of international financial transfers (including: The taxation of foreign currency gains and losses; The revaluation of foreign assets on the balance sheet; Operating holding and finance companies in the Netherlands and the Netherlands Antilles; Double tax agreements and disclosure agreements between tax authorities). Amsterdam (the Netherlands), June 9-10 (English).

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Georgetown University Law Center: The Fourth Annual Institute on Multinational Taxation (including: Current developments in international tax rules outside the U.S.; Tax treaties – the changing landscape). Washington, D.C., (U.S.A.), June 24-25 (English).

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SEPTEMBER 1982

36th Annual Congress of I.F.A.: I. The tax treatment of interest in international economic transactions. II. Taxation of payments to non-residents for independent personal services. Montreal (Canada). September 12-16 (English, French, German, Spanish).

Confédération Fiscale Européenne (C.F.E.): Third European Congress of Tax Consultants (including: State of tax harmonisation in Europe; The application of wealth taxes and taxes arising on death to foreign assets and liabilities; The practical application of international tax provisions (working groups)). Aix-la-Chapelle (Germany), September 30 to October 2 (English, French, German).

OCTOBER 1983

37th Annual Congress of I.F.A.: I. Tax avoidance/tax evasion. II. International problems in the field of turnover taxation. Venice (Italy), October 10-15 (English, French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

AMR International: 6-10 Frederick Close, Stanhope Place, London W2 2HD (United Kingdom).

Confédération Fiscale Européenne (C.F.E.): Secrétariat Général, Postfach 1340, Dechenstrasse 14, D-5300 Bonn 1 (Federal Republic of Germany).

Georgetown University Law Center: 600 New Jersey Avenue, N.W. Washington, D.C. 20001 (U.S.A.).

Inter-American Center of Tax Administrators (C.I.A.T.): Executive Secretary of C.I.A.T., P.O. Box 215 zona 1, Panamá.

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).

Institute for International Research: 70 Warren Street, London W1P 5PA (United Kingdom).

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

Practising Law Institute: 810 Seventh Avenue, New York, N.Y. 10019. (U.S.A.).

Seminar Services SA: 1 passage Perdonnes, CH-1005 Lausanne (Switzerland).

THIRD EUROPEAN CONGRESS OF TAX CONSULTANTS

under the auspices of the President of the Federal Republic of Germany

Professor Dr. Karl Carstens

from 30 September – 2 October 1982 in Aix-la-Chapelle, Eurogress

CONGRESS PROGRAMME (PROVISIONAL)

Thursday, 30 September 1982

09.00 Opening of the Congress:
Dr. Wilfried Dann, Steuerberater, President of the C.F.E.

09.15 PAPER:
Count Otto Lambsdorff, Federal Minister of Economic Affairs of the German Federal Republic, Bonn
Increasing Economic Relations in a United Europe

10.00 PAPER:
Christopher Tugendhat, Vice-President of the Commission of the European Communities, Brussels
State of Tax Harmonisation in Europe

11.00 PANEL DISCUSSION I
Open questions and possible conflicts following the implementation of the 6th EEC directive relating to VAT

Languages: English, French, German

Chairman: Dr. Wilfried Dann, President of the C.F.E.

Participants:
Allemagne: Mr. Geist
Belgique: Mr. Timmermann
France: Mr. Ebrad
Italie: Mr. Prof. Croxatto
Pays-Bas: Mr. Warning
Royaume-Uni: Mr. Pyne-Gilbert
Commission of the European Communities: not yet available.

13.00 Luncheon for all participants at the Eurogress

15.00 WORKING GROUP A 1
Tax problems of establishing business activities abroad by medium-sized enterprises

Languages: German, English

Referees:
Allemagne: Mr. Dr. Schelle
Pays-Bas: Mr. Udink
Royaume-Uni: Mr. Stitt

15.00 WORKING GROUP A 2
The application of wealth taxes and taxes arising on death to foreign assets and liabilities

Languages: German, French

Referees:
Allemagne: Mr. Prof. Dr. Wacker
Belgique: Mr. Brandès
France: Mr. Saint-Bauzel

15.00 WORKING GROUP A 3
The professional relationship between the tax consultant and his client

Languages: English, French, German

Referees:
Allemagne: Mr. Mittelsteiner
Irlande: Mr. Johnston
Italie: Mr. Bertorello

17.30 End of the professional part of the first day of the Congress

Friday, 1 October 1982

09.30 WORKING GROUP B 1
The practical application of international tax provisions

Languages: English, German

Referees:
Belgique: Prof. Dr. A. Tiberghien
Danemark: Mr. Jørgen Skou
Royaume-Uni: Mr. Jones

09.30 WORKING GROUP B 2
The taxation of foreign income and gains from foreign possession of individuals

Languages: French, German

Referees:
Allemagne: Mr. Dr. Rädler
Espagne: Mr. Santacana
Pays-Bas: Mr. Booij

09.30 WORKING GROUP B 3
Organizing and equipping a tax consulting practice

Languages: English, French, German

Referees:
Allemagne: Mr. Sebiger
France: Mr. Gumez
Pays-Bas: Mr. Telman

12.30 Luncheon for all participants at the Eurogress

14.00 PANEL DISCUSSION II
International tax control

Languages: English, French, German

Chairman:
Joseph Delattre, President of the Tax Committee

Participants:
Allemagne:
Belgique: Mr. Denys
Espagne: Mr. Gros
France: Mr. Delattre
Irlande: Mr. Bale
Pays-Bas: Mr. Smid
Royaume-Uni: Mr. Jenning
Commission of the European Communities: not yet available

16.30 PAPER:
Dr. Wilfried Dann, President of the C.F.E.

Perspectives for the Future of Tax Consulting in Europe

17.00 End of the Professional part of the second day of the Congress

TAX TREATY:
Netherlands Antilles – United States

On 4 February 1982 the U.S. Treasury released the following text of a joint statement relating to the recently concluded round of negotiations on a new income tax treaty between the Netherlands Antilles and the United States.

The Minister of Finance of the Netherlands Antilles, Mr. Marco J. de Castro, and the Assistant Secretary (Tax Policy) of the United States Treasury Department, Mr. John E. Chapoton, announced today that further negotiations between the Government of the Netherlands Antilles and the Government of the United States, for the purpose of agreeing on a new income tax convention, were held in Washington, D.C. from February 1 through 4, 1982. The chief negotiator for the United States was A.W. Granwell, International Tax Counsel, and the chief negotiator for the Netherlands Antilles was Harold Henriquez, Minister Plenipotentiary.

During these negotiations, there was a review of the main issues. There was a detailed discussion of the possible solutions to reconcile the respective tax, enforcement and economic policy goals of the two governments in light of the historical relationship between the two countries.

The two delegations will resume the negotiations shortly. The next meetings have been scheduled for the spring of 1982.

In the meantime, the present treaty relationship between the United States and the Netherlands Antilles will remain in effect and will be administered in accordance with its terms.

See for the text of the present tax treaty 31 *Bulletin for International Fiscal Documentation* 1977 at 399.

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IV. CONFERENCE DIARY: 37,95,143

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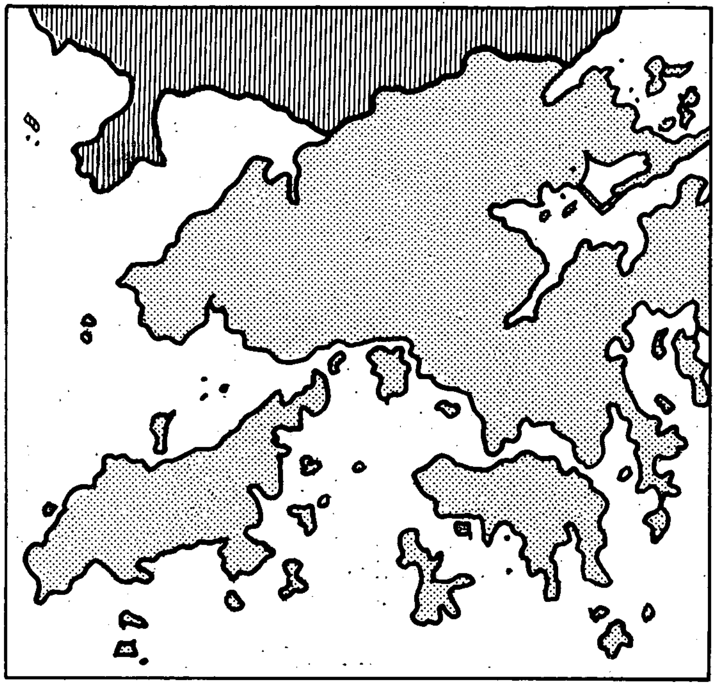
INHALTSVERZEICHNIS

SOMMAIRE

Hong Kong: More Tax Concessions

by Y.C. Jao *



In a previous article in this **Bulletin,** *the present writer summarized and discussed recent tax changes and reforms in Hong Kong from 1976 to 1981.[1] It was shown there that simplification and rationalization of Hong Kong's tax system in recent years has on balance resulted in a lower burden of personal taxation, a higher tax yield and a greater fiscal surplus. In the latest 1982-83 Budget presented by Hong Kong's new Financial Secretary, Mr. John Bremridge, on 24 February 1982, more tax concessions were announced. Some of the tax cuts, in particular the abolition of the interest withholding tax on foreign currency deposits, clearly have certain international implications. This short article aims to describe the tax concessions and analyze their economic significance.*

Tax concessions for 1982-83

Tax concessions proposed in the latest budget may be discussed under four headings as follows:

(a) Business taxation

In the previous fiscal year, the initial allowance for capital assets was raised from 25 to 35% to provide more incentive for entrepreneurs in replacing and upgrading their capital equipment, machinery and plant. In the latest budget, this initial allowance has been further increased to 55% for expenditure incurred on the provision of qualifying plant and equipment. As an example, an item of spinning or weaving machinery ranking for the annual rate of allowance of 30% will now qualify for a total write-off of 68.5% in the year of acquisition.[2]

A related concession concerns the allowance for industrial buildings. Under existing legislation, allowance for industrial building is granted by reference to the cost of construction only, no account being taken of the profit element in the final purchase price. This has now been amended so that both the initial and annual allowances for industrial buildings will henceforth be computed by reference to the net price paid by the final user. In Hong Kong, where until very recently profit margins in the property market have tended to be very high, the tax saving is not inconsiderable for a manufacturer who buys rather than leases a factory building for industrial production.

These concessions have been taken in recognition of the difficulties Hong Kong industrialists are now facing: world-wide recession, rising protectionism in developed countries, and growing competition from other low-wage developing countries. Such tax concessions may not go far enough in satisfying the clamour for more direct subsidy to the troubled industrial sector, but in the light of Hong Kong's traditional non-interventionist policy and philosophy, they probably represent the most the Government can do.

(b) Interest withholding tax

From the international point of view, a more important, and perhaps also more controversial, concession is the abolition of the interest withholding tax on foreign currency deposits. Debate on the pros and cons of this move has been going on in Hong Kong since at least 1970, when the territory began to emerge gradually as a financial centre. In the late 1960s several multinational banks had plans of establishing the Asian-dollar market – which was in effect an extension of the Euro-dollar market – in Hong Kong, but they were frustrated by the refusal of the Hong Kong Government at that time to abolish the interest withholding tax on foreign currency deposits. As a result, the Asian-dollar market was launched in 1968 in Singapore, whose government was only too glad to grant tax exemption as an inducement to multinational banks for setting up an offshore banking centre. Since then, the two city-states have been competing fiercely for the position of the leading financial centre for the Asian-Pacific

* Reader in Economics, University of Hong Kong.

1. Y.C. Jao, "Tax Changes and Reforms in Hong Kong", 35 *Bulletin for International Fiscal Documentation* 8-9 (1981), pp. 401-07.
2. 55% + (45% x 30%) = 68.5%.

Region. Both in the process have grown enormously in financial stature. Most analysts agree that, being the host country for the Asian-dollar market, Singapore clearly leads as a funding centre, while Hong Kong – which has a much larger economy, is more centrally situated and is geographically closer to such large borrowers as the Philippines, South Korea, Taiwan, and eventually China – is more favoured as a syndication centre.[3] Hong Kong is reputed to be next to only London and New York in having the largest number of foreign banking institutions represented in one form or another.

With the removal of the interest tax on offshore currency deposits, it is widely expected that at least part of the US$80 billion Asion-dollar market based in Singapore will be repatriated, though not immediately, to Hong Kong. Singpore will still grow as a financial centre, but not at the fast rate as in the past. In any case, it will no longer be in a position to virtually monopolize the Asian-dollar market. Hong Kong in the meantime will grow both as a funding and syndication centre, a trend that will be conducive to the much needed diversification of its economy.

Hitherto there have been at least two major reasons for opposing the abolition of interest tax on foreign currency deposits. The first is the loss in revenue to the Treasury, particularly when interest rates remain at a historically high level. However, the international banking lobby has apparently succeeded in persuading the authorities that the loss in fiscal revenue will be more than offset in the long run by visible and invisible incomes resulting from Hong Kong's further development as a financial centre. The second is the fear that, if the corresponding tax on domestic currency deposits is not also abolished, a large-scale switching from domestic to foreign currency deposits may take place, which in turn will lead to an unacceptable depreciation of the Hong Kong dollar. As a precaution against this danger, it was announced in the Budget that the interest withholding tax on Hong Kong dollar deposits would be simultaneously lowered from 15% to 10%. The critics, however, maintain that this reduction does not go far enough to forestall the possibility of currency switching. Another valid point raised by the critics is that the differential treatment of foreign and domestic currency deposits violates one of the fundamental precepts of public finance, namely, horizontal equity.

(c) Personal taxation

In the previous article, the present writer described how various allowances have been increased over the years, the net effect of which has been to mitigate the tax burden of middle income groups, and to exempt lower income groups from personal tax altogether.

In the current Budget, more allowances have been granted to those liable to Salary Tax and to those who elect for Personal Assessment. First, the level of personal allowances is raised from HK$15,000 to HK$20,500 for single persons and from HK$30,000 to HK$41,000 for married couples. The present supplementary allowance of HK$7,500 each for the taxpayer and his/her spouse remains unchanged, so that the total allowances are now HK$28,000 for a single person and HK$56,000 for a married couple. The new allowances are nearly 25% higher than the existing ones, and considerably in excess of the current rate of inflation (about 15%). Second, child allowances are raised from HK$7,000 to HK$8,000 for the first child, and from HK$5,000 to HK$5,500 for the second child, but present allowances for the third to ninth child remain unchanged. Third, the dependent parent allowance is also increased from HK$7,000 to HK$8,000. All told, these increased allowances will exempt 92,000 persons from tax liability. In addition, an estimated further 55,000 persons who elect Personal Assessment will also benefit through reduced liability.[4] As an illustration, Appendix A shows Salary Tax payable by various taxpayers with the same income but in different personal circumstances. As can be seen clearly, at the same salary income of HK$108,000 (= US$18,462) per annum, which is fairly typical of middle-class income level in present-day Hong Kong, the effective tax rate under the new system of personal allowances ranges from 13.9% for a single person to only 1.7% for a married person with two children and two dependent parents. This compares favourably with those under most tax jurisdictions, with the exception of tax havens.

(d) Estate duty

The exemption limit for Estate Duty (inheritance tax) was raised last year to HK$1 nillion, and this is now further doubled to HK$2 million, in recognition of rising asset values in an inflationary environment. Concomitantly, the marginal rates applicable to estates over HK$2 million have also been revised, ranging from 10% to 18%. Details of the new schedule are presented in Appendix B. Finally, the principal matrimonial home of the deceased, who leaves a surviving spouse, is also exempted from Estate Duty.

CONCLUSIONS

Hong Kong's low tax policy, in so far as it minimizes disincentive effects on saving, investment and work effort, has been one of the contributing factors for the territory's remarkable economic growth – averaging some 9% per annum in real terms – in the post-World War II period. Further measures have been taken since 1976 to provide more tax relief to middle-income groups and incentives for business investment. In effect, Hong Kong has been pursuing the basic tenets of what is now fashionably called "supply-side economics", without, however,

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3. For a more detailed analysis, see S.Y. Lee and Y.C. Jao, *Financial Structures and Monetary Policies in Southeast Asia* (London: Macmillan, 1982), Chapters 2, 3 and 9.

4. The Hong Kong tax system is a schedular one, i.e. taxes are levied separately on different sources of income, such as salary, interest, profits, etc. Personal Assessment is a voluntary option open to resident taxpayers who choose to aggregate their incomes from all sources for tax assessment, against which personal allowances are granted, which would otherwise be confined only to those who pay Salary Tax.

self-consciously adopting its more extreme dogmas.

Moreover, since various tax concessions have been granted on the basis of a healthy state of fiscal surplus and reserve, Hong Kong has been able to avoid the serious complications arising from an over-hasty and doctrinaire application of "supply-side economics".[5]

5. Despite tax concessions totalling some HK$1,370 million, the Hong Kong Government is still able to budget for a surplus of some HK$2,300 million in the current 1982-83 fiscal year. The accumulated fiscal reserves as at 1 April 1982 are estimated at about HK$23,000 million (approximately US$3,930 million).

Appendix A

Tax payable by various taxpayers with same annual income
(Hong Kong dollars)

	Single $	*Single with 2 dependent parents* $	*Married with no children* $	*Married with 2 children* $	*Married with 2 children and 2 dependent parents* $
Annual salary income	108,000	108,000	108,000	108,000	108,000
Less: personal allowance	28,000	28,000	56,000	56,000	56,000
	80,000	80,000	52,000	52,000	52,000
Less: child allowance	—	—	—	13,500	13,500
Less: dependent parent allowance	—	16,000	—	—	16,000
Net chargeable income	80,000	64,000	52,000	38,500	22,500
Tax thereon	15,000	11,000	8,000	4,700	1,875
Effective tax rate	13.9%	10.2%	7.4%	4.4%	1.7%

Source: *The 1982-83 Budget Speech*, 24 February 1982.

Appendix B

Marginal rates for estate duty

New schedule

Net estate value (HK$)	*Tax rate (%)*
2,000,001 – 2,500,000	10
2,500,001 – 3,000,000	12
3,000,001 – 3,500,000	14
3,500,001 – 4,000,000	16
4,000,001 and above	18

15 Percent Tax – and Still Taxpayers Grumble

by Mary Lai


Mr. Anthony Au-Yeung, Deputy Commissioner of Inland Revenue of the Hong Kong Government, said the Government's policy is to keep the rate of taxation low in an attempt to provide an incentive for local investment and there is more than sufficient revenue to cover public expenditure.

Like all taxpayers around the world, Hong Kong people complain of the tax burden imposed on their shoulders by their government.

However, Hong Kong, the tiny British territory perched on the edge of China, enjoys one of the lowest and simplest forms of taxation in the world. The current standard rate of 15% has been in force since 1 April 1966.

"Despite the low taxation rate, Hong Kong's internal revenue yield has increased from HK$2,896.4 million (£263.31 million; US$526.62 million) in the 1975-76 fiscal year to HK$11,231.4 million (£1,021 million; US$2,042 million) in the 1980-81 fiscal year", said Mr. Anthony Au-Yeung, Deputy Commissioner of the Inland Revenue Department of the Hong Kong Government.

In return for his tax contribution (and a single person earning less than HK$2,333 (£212.12; US$424.24) a month pays nothing), the man-in-the-street gets a first class police force, 9 years of free and compulsory education up to the age of 15, medical services at a nominal charge of HK$3 (27p; US$0.55) per visit and a host of social security schemes.

"The government's policy of maintaining a comparatively low level of taxation plays an important role in economic stability and provides an incentive for investment. Furthermore, due to growing prosperity, Hong Kong's recurrent revenue is more than sufficient to finance its public expenditure", said Mr. Au-Yeung.

In his budget speech to the Legislative Council on 24 February 1982, Hong Kong's Financial Secretary, Mr. John Bremridge, said that he does not believe that it is generally appropriate for the Government to raise taxation when it does not need the money – either for its immediate expenditure or in order to further strengthen prudent reserves.

Hong Kong's Inland Revenue Ordinance provides for the levying of four separate direct taxes on income arising in or derived from Hong Kong for a year of assessment which ends on 31 March. Based, as it is, on a territorial source of income criterion (limiting the charge to tax on income from Hong Kong only), residence/non-residence is not a factor in the system. By the same token there are no tax incentives (other than the low tax rates charged) for overseas investors wishing to set up business or work here. The taxes levied under the Ordinance are profits tax, salaries tax, property tax and interest tax.

Profits tax is charged on profits arising in or derived from a trade or business carried on in Hong Kong. Profits of unincorporated businesses are taxed at 15% and corporations at 16.5%. Generally, all expenses incurred in the production of assessable profits are deductible, as are charitable donations to the extent of 10% of net assessable profits. There is no withholding tax on dividends paid by corporations and dividends received from corporations are exempt.

Salaries tax is calculated on a sliding scale which varies from 5 to 25% on HK$10,000 (£909.09; US$1,818.18) segments of assessable income, that is, income after the deduction of personal allowances. However, the overall effective rate is limited to a maximum of 15% of income before the deduction of personal allowances. These allowances are: for the taxpayer HK$28,000 (£2,545.45; US$5,090.91); for his wife HK$28,000; for his children a maximum of HK$25,500 (£2,318.18; US$4,636.36) ranging from HK$8,000 (£727.27; US$1,454.54) for the first child to HK$1,000 (£90.9; US$181.82) for the ninth; and HK$8,000 for each of his or his wife's dependent parents.

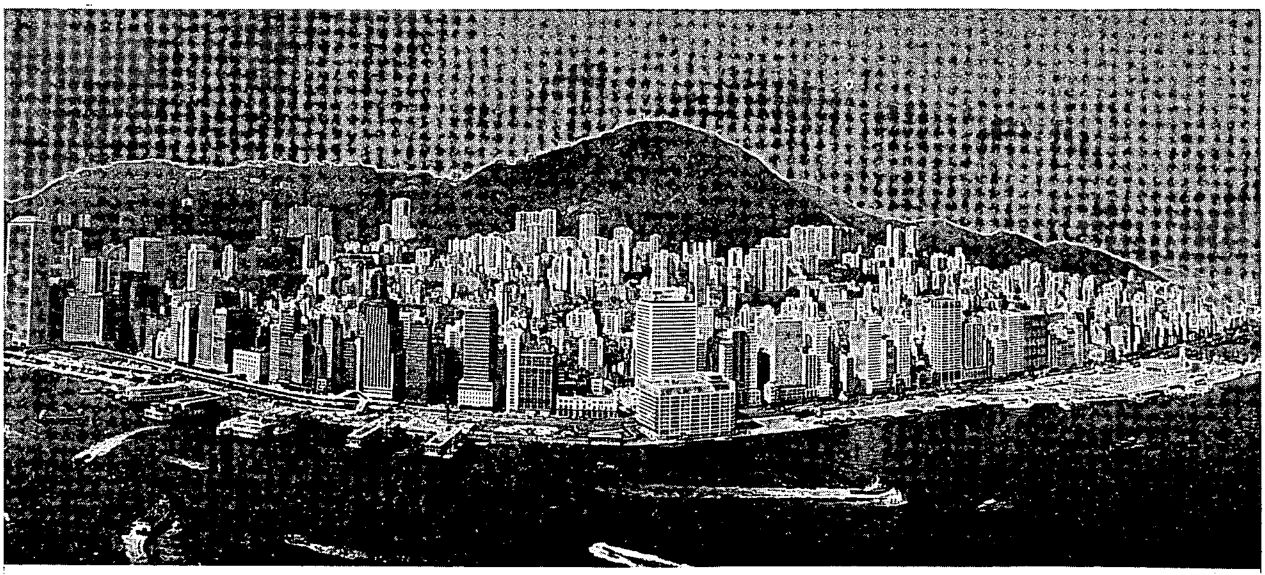
Apart from the deduction of expenses necessarily incurred in the production of income, and charitable donations up to 10% of taxable income, there are no other allowances.

With the exception of property occupied by an owner for his own residential purposes, vacant premises and property in certain undeveloped parts of the New Territories, property tax is charged at the standard rate of 15% on the net estimated rental value and is levied annually on the owner of land and/or buildings in Hong Kong.

Property owned and used for business purposes by a corporation carrying on business in Hong Kong is exempt from property tax; although if there is any profit derived from the ownership, it is chargeable to profits tax.

Interest tax is charged on Hong Kong dollar time deposits with banks and deposit-taking companies at a flat rate of 10%. Foreign currency deposits placed with licensed banks and registered and licensed deposit-taking companies are exempt from interest tax. Interest (other than interest on foreign currency deposits placed with licensed banks and deposit-taking companies) in the hands of a corporation carrying on business in Hong Kong is chargeable to profits tax because any interest so received is deemed to be part of the profits of the corporation.

"Unlike many other territories, Hong Kong's tax legislation does not charge any sources of earnings and profits



Hong Kong, the tiny British territory on the edge of China, enjoys one of the lowest and simplest forms of taxation in the world. The current standard rate of income tax of 15% has been in force since 1 April 1966.

which fall outside these four categories", said Mr. Au-Yeung.

Other sources of internal revenue include estate duty, stamp duty, entertainments tax, betting duty, business registration fees and hotel accommodation tax.

In the current financial year, 1 April 1981 to 31 March 1982, it is estimated that internal revenue will account for HK$14,672 million (£1,333.82 million; US$2,667.64 million) or 41.7% of the Government's total revenue.

The largest contribution to the internal revenue pot comes from profits tax which accounts for HK$7,095 million (£645 million; US$1,290 million) or 48.4% of the total internal revenue.

"Our philosophy is not only to keep each and every taxation levy, be it direct or indirect, simple and easy for the taxpayers, but also productive and inexpensive for the Government to administer", said Mr. Au-Yeung.

The Inland Revenue Department is staffed by some 3,300 officers and is divided into 5 operational units, each of which is headed by an assistant commissioner.

The cost of tax collections in Hong Kong is among the lowest in developing and developed countries. It represents something on the order of 1% of total revenue collections, which is very satisfactory.

While conceding that tax evasion exists in Hong Kong, Mr. Au-Yeung said it is a problem from which no country in the world is spared.

"We have had some measure of success in the detection of evasion over the past several years. In 1981, our Investigation Unit completed investigation into 240 cases of tax evasion involving omitted income and profits amounting to HK$£380 million (£34.55 million; US$69.1 million)."

Under present legislation, the maximum penalty for tax evasion is 3 years imprisonment plus a monetary penalty (over and above the basic back tax) of 300% of the total amount of tax evaded.

Mr. Au-Yeung said a number of statutory provisions were first introduced in 1969 which provided the basic background to the expansion of investigation work. These involved the power to require a statement of assets and liabilities and of outgoings and receipts; the power to apply for a search warrant, with the consent of magistrates, to enter premises and seek books and records; the requirement for taxpayers to maintain sufficient records to enable profits to be ascertained and the requirement to retain those records for not less than 7 years.

Preventive measures include the supply of more informative and illustrative tax returns to taxpayers and publicity on both television and in the printed media reminding taxpayers of their obligation to notify the department of their income.

There has been pressure in recent years for separate taxation for married women. At the present their income is assessed as part of their husbands' earnings. Mr. Au-Yeung reiterated what the Financial Secretary said in his budget speech – that the Government would have another look at the question of separate taxation next year.

"Separate taxation for married women will cost the Government no less than HK$200 million (£18.18 million; US$36.36 million) in lost internal revenue a year.

"Such a proposal, apart from policy considerations, will involve considerable changes in administrative procedures and computer programmes; these will take time to study and evaluate to ensure a smooth and efficient transition if the decision is taken to implement separate assessment."

Mr. Au-Yeung said given the low level of direct taxation, Hong Kong will not introduce a "pay-as-you-earn" collection system in the foreseeable future because of a variety of reasons. "Firstly, the system is rather complicated and expensive to operate. Certainly, it is not as simple as people think it is.

"Secondly, experience elsewhere has shown that there is a real cost for employers, requiring both money and time in keeping costly tax records. This in a way means that the administration of the collection system will be passed on from the Government to the employer.

"Thirdly, it requires a large policing operation to ensure that the tax is correctly deducted and promptly remitted by employers to the Inland Revenue Department. The chance of losing revenue is obviously much greater.

"Lastly, it deprives taxpayers of the opportunity of profitably utilising the money set aside for paying tax before the tax bill arrives. The Tax Reserve Certificate System is far more satisfactory than the pay-as-you-earn system."

In Hong Kong people liable for tax may purchase these certificates which they can present to the Inland Revenue Department when the bill arrives. These certificates carry interest if they are used for payment of tax.

Turning to the future, Mr. Au-Yeung said the philosophy of keeping taxation simple and inexpensive for both the Government and the taxpayer will be closely adhered to. Under the prevailing economic circumstances and conditions of Hong Kong, it is believed that a comparatively low level of taxation contributes significantly to enlarging the size of the trade sector, generally balances economic prosperity and thus increases revenue yields despite high tax thresholds.

There is no perfect world. People falling into the tax net often complain of the tax burden. Almost without exception, Hong Kong taxpayers join the chorus of complaints about heavy taxation, but perhaps they should count their blessings.

Singapore's 1982 Budget: A Summary

by Lee Fook Hong*

Contents

On 5 March 1982, the Minister for Trade and Industry, Dr. Tony Tan Keng Yam, presented his 1982 Budget to the Parliament of the Republic of Singapore. This is Dr. Tony Tan's first Budget Speech since taking over in June 1981 from Mr. Goh Chock Tong as Minister for Trade and Industry.

Following established practice, Dr. Tony Tan presented his Budget Statement in three parts. In his first part, he reviewed the progress of the economy in 1981 and the economic policy of the Government. The second part dealt with Main and Development Estimates for the financial year 1982. The Revenue Estimates and tax changes were dealt with in the final part of his Budget Statement.

SECTION I

(1) Singapore's economy in 1981

In his review of the progress of Singapore's economy in 1981, the Minister briefly highlighted the performance and said: "As expected, 1981 was a very difficult year for the world economy. Very low or negative growth rates were recorded in the United States, France, West Germany and Great Britain. The number of people without work in Europe and the United States rose to post-war record levels. In the UK, 3 million people, a number greater than the population of Singapore, were without jobs. In the United States, those jobless numbered 9.5 million. Because of the grim economic conditions in these countries, world trade did not grow at all.

In comparison with the depressing economic conditions in the West, the performance of the Singapore economy in 1981 was an enviable one. Our economy grew at just under 10%, only marginally less than in 1980. We are fortunate that the Asia-Pacific region, with its abundant natural resources and political stability, is one of the growth areas in the world today. The North East Asian developing countries of Hong Kong, Taiwan and South Korea and our ASEAN neighbours, continued to register growth rates of 5-10%. Japan, Australia and New Zealand also did relatively better than other industrialised countries."

* FCIS, FAIA.

At the end of the review, the Minister pointed out that Singapore's good economic performance had only one unsatisfactory aspect, i.e. a stubborn inflation rate. Mainly because of rising food prices, inflation in 1981 did not subside as much as Singapore would like to see. Consumer prices rose by 8.2%, marginally less than in 1980. However, inflation in Singapore was again lower than the inflation in the industrialised countries and that of her neighbouring countries.

(2) Economic policy

The Minister then proceeded to elaborate on specific areas of economic policy, namely, industrial development, research and development, trade development, financial services, computerisation, tourism, manpower development, enercy development and construction.

(a) Industrial development

On industrial development, the Minister said it was progressing well under the 3-year wage correction policy. Investment commitments (excluding petrochemicals) amounted to S$1.9 billion, a new record.

(b) Research and development (R&D)

On research and development, Dr. Tony Tan reported that considerable success had been achieved in the promotion of R&D activities and that several projects, with significant R&D content, by international firms such as Nestle, Olivetti, Varta and Sord Computer were now in the pipeline. Other firms would also bring in major R&D facilities as part of the investment projects. Further progress was expected to be seen in industrial R&D activities in electronics, computer hardware and software, pharmaceuticals, robotics and automation systems and biotechnology.

(c) Trade development

On trade development, the Minister reported that two overseas trade offices were set up in 1981 in Beijing and Rotterdam and that new offices were planned in Europe and West Asia in 1982. Apart from servicing trade enquiries and coordinating trade fairs and missions, the overseas offices were also active in encouraging multinational companies based in this region to organise missions to source manufactured parts, components and other intermediates for their parent companies at home.

(d) Financial services

Dr. Tony Tan reported that in the last decade, Singapore had laid a sound infrastructure for international financial services. In the next 10 years Singapore will have to develop even more sophisticated services for a larger international clientele. Emphasis was being given in particular to the development of the foreign exchange market, both in the depth and breadth of services provided, and to the loan syndicated market.

Dr. Tony Tan disclosed that in 1981, 11 offshore banks, 4 merchant banks and 5 insurers opened offices in Singapore. He remarked that local banks and financial institutions were becoming increasingly aware of the more computitive domestic and international environment and of the need to be more productive.

Announcing that the Automated Cheque Clearing System would start on 1 January 1982 Dr. Tan said, "This is expected to improve productivity as well as provide better services to bank customers. To increase the spectrum of services provided, new services such as a financial futures market and a US Dollar Clearing system will be investigated. At the same time, efforts will be made to upgrade the quality of services provided by the Gold Exchange of Singapore. Floating rate certificates of deposit denominated in Singapore dollars were issued for the first time last year, giving the public another avenue for investing in medium and long-term instruments."

(e) Computerisation

On computerisation, the Minister said further progress had been made in promoting the wider use of computers in Singapore. The National Computer Board officially came into being on 1 September 1981. It would promote computerisation in the civil service, establish and maintain standards of computer training and develop Singapore into a computer software centre.

(f) Tourism

On tourism, the Minister reported that in 1981, 2.83 million visitors came to Singapore, an increase of 10% despite the more difficult economic conditions in the major tourist-generating countries.

(g) Manpower development

On manpower development, the Minister announced that the Skills Development Fund had widened the scope of its financial assistance under various training schemes. He had plans to upgrade the skills of existing workers on a wider scale through the establishment of an Institute of Continuing Occupational Development.

(h) Energy development

The Minister was very pleased to report that there were indications that Singapore's economy was responding well to the call to conserve energy.

The Minister said that in spite of success, Singapore should continue to encourage energy conservation through persuasion, incentives and disincentives.

It was announced in 1981 that the provision of accelerated depreciation in the Income Tax Act would be extended to cover approved energy saving expenditure incurred by non-industrial enterprises. The guidelines for these incentives had been finalised. (See Annex I.)

(i) Construction

Emphasising the need to promote mechanisation in the construction industry, Dr. Tony Tan announced that the Ministry of National Development and the Ministry of Finance had implemented a loan scheme at concessionary rates of interest to finance the purchase of machinery as well as a scheme for according accelerated depreciation allowances for construction machinery.

To give a further push to the pace of mechanisation in the industry, an investment allowance scheme, similar to that currently applicable to certain manufacturing projects, will be made available to the construction industry.

Approved fixed investment in machinery and equipment by construction firms from 1 April 1982 to 31 March 1987 will enjoy an investment allowance of up to 50%.

(j) Concluding remarks on economic policy

In his concluding remarks on economic policy, the Minister conveyed the following message to Singaporeans: "We must pull up our socks if we want to avoid being dragged into the quagmire of economic stagnation. The Government will govern firmly and fairly, steering our economic engine with the policies I have just presented and the Budget and tax changes that follow. Barring a major adverse turn of events, and this caveat bears repeating, because we live in a troubled world where economic disasters have become the rule rather than the exception; if we cooperate and work with the same determination as last year, we may hope to pull through 1982 with a respectable rate of economic growth yet again."

SECTION II

The financial year 1982 Budget

In the second part of the Budget Statement, the Minister elaborated on Main and Development Estimates for the financial year 1982.

The Minister outlined to the Parliament the following objectives of the Budget:

- Increase the supply of skilled technical and professional manpower needed to facilitate the restructuring and upgrading of the economy.
- Step up infrastructural, industrial and commercial development so as to sustain economic growth and economic restructuring.
- Moderate the construction programme to meet the rising demand for housing units.

SECTION III

(1) Revenue

On the revenue estimates, the Minister reported as follows:

"Income tax, as always, is the largest single source of revenue. Income tax collections in FY 1982 are expected to be high because of the economic growth in 1981. The total collection is estimated at S$2,930 million, representing an increase of S$330 million or 12.7% over the revised estimates for FY 1981. Corporate income taxes account for 72% of the total collection."

(2) Tax changes

For the financial year 1982, the Minister did not announce any new taxes or increase in the rates of existing taxes. Instead he introduced the following concessions for individuals and companies:

(i) Tax changes for individuals

(a) Tax on PUB bills

With effect from 1 April 1982, the fixed charges in the PUB bill will not be included for the purpose of computing the 10% tax. These changes are sanitary appliance fee, domestic refuse charge, rental for appliances and night soil removal fee. The tax, therefore, will be imposed on only the total of electricity, gas and water charges, and water-borne fee where these charges exceed S$80. The tax will remain at 10% of the amount in excess of S$80.

(b) Contributions to Central Provident Fund (CPF) and approved pension and provident funds

With effect from Year of Assessment 1983, all statutory CPF contributions and contributions to designated approved pension and provident funds will be fully tax deductible. Where such contributions exceed S$5,000, no deductions will be allowed for life insurance premiums and other voluntary contributions to superannuation schemes. Where the statutory contributions do not exceed S$5,000, the maximum amount deductible for all contributions to CPF and approved pension and provident funds and life insurance premiums will be S$5,000.

(c) Aged dependant relief

The Minister said he intended to make two revisions to the aged dependant relief. A taxpayer can currently claim a relief of S$750 for each aged parent or grandparent living with him, subject to a maximum of two. For the relief to be allowed, one of the conditions is that the aged dependant must not have an income of more than S$750 in the year.

With effect from Year of Assessment 1983, the relief will be raised to S$1,000 per aged dependent. As a further relaxation of the conditions for eligibility of the relief, the relief will be allowed so long as the dependant has income no greater than S$1,500 in the year.

(d) Estate duty

On estate duty the Minister said, "On 1 January 1981 the specific exemption for residential properties was raised from S$200,000 to S$600,000. The exemption limit for assets other than residential properties remained at S$100,000.

"As a further concession to promote home ownership, the exemption limit for residential properties will be extended to include the *full* value of any one residential property. In other words, the exemption limit will be S$600,000 or the full value of any one residential property, whichever is the higher.

"In line with income tax deductibility of CPF contributions, exemption will be given on *all* CPF balances of the estate with the Fund. It will not include amounts withdrawn by the deceased during his lifetime under the approved schemes and not refunded to the CPF. Where the CPF balance exceeds S$100,000 no further exemption will be given for other assets, except for those qualifying for the exemption on residential properties. Where the CPF balance does not exceed S$100,000, the exemption limit of S$100,000 for assets other than residential properties will apply to all such assets, including the CPF balance.

"This concession will also apply to all approved provident funds which were *in lieu* of CPF.

"To encourage offshore gold transactions as well as to further develop the gold market, gold deposits with bullion companies held by foreigners, who are neither resident nor domiciled in Singapore, will not be liable to estate duty."

The above concessions will take effect from 1 April 1982.

(ii) Tax changes for companies

(a) Stamp duty

Stamp duty on ACU offshore loan agreements was abolished on 1 April 1980. However, loan agreements which were signed outside Singapore will still be subject to ad valorem stamp duty up to a maximum of S$500 when repatriated to Singapore. As a modest concession towards facilitating loan syndication activities in Singapore, the Minister had agreed to allow ACU offshore loan agreements which were signed prior to 1 April 1980 to be repatriated to Singapore without being liable to stamp duty as from *1 April 1982*.

(b) Road tax on SBS and CSS buses

Irrespective of the size or engine capacity of the bus, road tax will be rationalised with effect from 1 April 1982.

(c) Capital allowances for company registered cars

Under the current Income Tax legislation, capital allowances can be claimed on company registered cars. The ceiling of the capital allowances was last raised from S$15,000 to S$25,000 on 1 April 1979. The Minister has decided to increase this ceiling further to S$35,000 to bring it more in line with present prices of cars, with effect from 1 April 1982.

(d) Financial leasing

Various representations had been made by leasing companies and financial institutions for liberalisation of the present tax laws in order to promote financial leasing in Singapore. One of the proposals was that the residual value of the end of the lease period should be nominal or of a minimum acceptable value. The basic tax principle has always been adopted by the Tax Department that if an asset is disposed of, it must be or so deemed to be sold at the open market price.

The Minister has now agreed with the recommendation of the Tax Department to adopt the basis of open market price of determination of the residual value at the end of the lease period.

A balancing charge will be imposed if the open market price is higher than the written-down value at the time of disposal. If the open market price is lower than the written-down value, then a balancing allowance will be given.

The Minister emphasised, "It is important that a distinction should be made between a sale agreement and a lease agreement. For tax purposes, an agreement will not be considered as a genuine lease agreement if it provides for any of the following:

(i) The lessee is given an option to purchase the asset during the lease period or at its expiry;
(ii) Where there is no option to purchase, the lessee during the lease term or upon its expiry acquires the asset at below open market price;
(iii) The rental payments during the initial lease term constitute almost all or at least 90% of the acquisition cost and incidental expenses.
Additionally, either the lease term is shorter than the useful life of the leased asset, or the leased asset is not marketable and is a special purpose property, and the lessor has no intention to recover the asset;
(iv) The original lease agreement provides for extension or renewal of the agreement at less than 15% of the rental in the primary lease agreement; and
(v) The periodic lease payments are uneven and/or exceed the current fair rental value.

"Transactions involving members of a group or related persons which are primarily motivated by tax manipulations will not be treated as genuine lease agreements. However, transactions which are done at arm's length are acceptable. A transaction is not considered to be at arm's length if a member of the lessee group lends to the lessor funds for the acquisition of the asset or guarantees any debt of the lessor incurred in connection with the lease. A transaction will also be disqualified if the leasing company is specially incorporated for the purpose of leasing the assets to the related companies. It is deemed to be so incorporated if, for any of its financial years, the value of its contracts entered with independent persons constitutes less than 50% of the total value of its contracts for that year.

"Sale and lease-back transactions are generally not accepted as genuine lease agreements. They are treated as loans rather than lease agreements. However, the Tax Department will accept sale and lease-back transactions as genuine lease transactions if the equipment is sold to the lessor before it is put to use in the lessee's trade and the sale is made at not more than the acquisition price which the lessee pays to the supplier. The lessee must also not be given capital allowances for the equipment before its sale to the lessor.

"Leveraged leases will be treated on an individual basis, upon application to the Tax Department.

"The Tax Department will give accelerated depreciation to the lessor on equipment leased to a lessee who would be eligible for the accelerate depreciation allowances if the equipment is subsequently leased to another lessee who is also eligible for such allowances. Otherwise the depreciated value of the equipment will be written off on a straight line basis over the remaining statutory life of the equipment. However, the terminal payment paid by the lessee to the lessor as compensation for terminating the lease will be subject to tax."

(3) Pensions

On pensions, the Minister announced, "From 1 April 1982, the Singapore Allowance which will replace the present New Singapore Allowance will be paid to all locally domiciled Government pensioners whose gross pensions (i.e. pensions plus New Singapore allowance) are less than S$850 a month.

"Those who are drawing pensions, excluding the current new Singapore Allowance, of S$775 per month or less will be paid a Singapore Allowance at the flat rate of S$75 per month. Those drawing pensions of more than S$775 per month but less than S$850 per month will be paid the Allowance on a reducing scale such that the pension plus the Singapore Allowance equals S$850 per month."

(4) Conclusion

In concluding his Budget Statement the Minister said, "This Budget reflects our economy which is on an even steady keel. I have deliberately not introduced any new taxes or raised the rates of existing taxes in order not to increase the tax burden. However, I hope that Singaporeans will not look on this Budget as an occasion for rejoicing but rather as a respite to enable them to consolidate and improve their position.

"To perform better we must upgrade our present skills and seek to acquire new ones. There is no other way and we must not be deflected from this task. We have to work as a team in our homes, in our work places, in our community and as a nation. Other than a favourable location, we have no natural resources. It is only by working harder than others that we can make a future for ourselves and our children.

"In the process of assimilating new technology and modern management methods, we must not forget the traditional values which have served as the bed-rock of our society. We must not abdicate our moral duty to look after those wo are weak, old and infirm. Children must not forsake their parents and grandparents. The aged and the weak need more than material care; they have emotional and spiritual needs which only their children and their family can provide. It is the responsibility of the young to look after the aged. After all, the success of children in later life is built on the sweat and toil of their parents. Children therefore owe it to their parents to enable them to live out the autumn of their lives not only with pride and dignity, but also surrounded by affection and care.

"1982 will be a grim year. The problems of unemployment and protectionism in the industrialised countries will not abate. Indeed we will be lucky if these problems do not escalate. Singapore will, before very long, be buffeted by the turbulence of the international economic storm. We can go under, or we can resolve to ride out the storm. To do this we must keep trim and be prepared to lend each other a hand when the need arises. Then, when the storm subsides we shall surge forward again."

COMMENTARY ON THE 1982 BUDGET

(1) Man in the street

Some Singaporeans feel that the 1982 Budget is reasonable as it caters for both high and low income earners. It shows trends in the right direction especially where helping the poor and the aged is concerned.

However, some feel that the pensioners should get a little more increase in the Singapore Allowance and there should be some increases in personal reliefs such as reliefs for maintaining wife and children and further increases in reliefs for dependants.

Most people welcome the Budget as it has not introduced any new taxes or increases in the rates of taxes. While rejoicing over the tax concessions, some feel that these are on the small and simple things and accordingly they have only marginally impact.

(2) Leaders in commerce and industry

While welcoming the Budget, some leaders in commerce and industry are of the view that more incentives could have been given in the industrial and commercial sectors. In view of the gloomy economic scenario in 1982, more liberal concessions should have been incorporated.

Financial leasing companies express some satisfaction over the liberalisation of tax law to help promote the financial leasing business in Singapore. They are very pleased over the accelerated depreciation concession to be granted on equipment leased to lessees.

Bankers are disappointed that the Minister did not react to Hong Kong's decision to abolish taxes on all foreign currency deposits. They think this will undermine Singapore's competitive position.

Bullion companies do not react very positively to the tax concession that a foreigner's gold deposits will not be liable to estate duty, as they feel such concessions will not have an immediate effect on the daily turnover of the Gold Exchange of Singapore.

Other leaders in commerce and industry feel that the waiver of the stamp duty on ACU offshore loan agreements is but a modest concession. It is unlikely to have any major impact on Singapore's effort to be competitive with other financial centres in the region.

While welcoming the tax changes in relation to ACUs and leasing, some businessmen are surprised that there are no new or additional measures to boost the economy in view of the difficult times ahead. They are disappointed over the following:

(a) no reduction in the 40% corporate tax; and
(b) no reduction in the 2% payroll tax.

On the whole, most people regard the Budget as an acceptable one although they expect the Minister to grant more tax incentives or concessions.

ANNEX

Accelerated depreciation allowance to approved energy-saving equipment in non-industrial enterprises

Accelerated depreciation allowance will be granted to non-industrial enterprises for capital expenditure on two categories of energy equipment:

(A) Replacements for machines and equipment which consume large amounts of energy. The objective is to encourage enterprises to undertake more frequent changes of major energy utilising machines in order that old and energy wasteful machines could be replaced by new energy efficient machines. The incentive is aimed at the major and not the minor energy utilising machines.

(B) Specialised energy-saving equipment and devices which reduce the usage of energy. The objective is to induce enterprises to invest in these specialised energy-saving equipment and devices.

The non-industrial enterprises that can qualify for this accelerated depreciation allowance are as follows:

(a) Hotels
(b) Restaurants
(c) Commercial buildings
(d) Shopping complexes
(e) Hospital buildings
(f) Apartment buildings
(g) Recreation centres
(h) Theatres/cinemas

This list may be modified or updated from time to time.

Under this scheme, the accelerated depreciation allowance will be for a period of three years at an annual rate of 33⅓% in respect of the capital expenditure approved.

Category A

Criteria for Granting Accelerated Depreciation Allowance to Replacement Machines and Equipment

(1) The machine or equipment will have to be in the List of Approved Replacement Machines and Equipment.

(2) A professional engineer will have to certify that energy will be saved by installing the replacement machine or equipment.

List of Approved Replacement Machines and Equipment

(i) Central air-conditioning system excluding ducts and pipes
(ii) Boilers
(iii) Water pumping systems
(iv) Washing/dry-cleaning machine systems
(v) Refrigeration systems
(vi) Lifts and escalators

This list may be modified or updated from time to time.

Category B

Criteria for Granting Accelerated Depreciation Allowance to Energy Saving Equipment and Devices

The equipment or device must be on the List of Approved Energy Saving Equipment and Devices.

List of Approved Energy Saving Equipment and Devices

(i) Solar heating and cooling systems
(ii) Solar energy collection systems
(iii) Heat recovery system
(iv) Power factor controllers
(v) Energy saving devices of approved types

This list may be modified or updated from time to time.

Summary of new tax concessions in the 1982 Budget

For ease of reference, below is a brief summary of new tax concessions announced in the 1982 Budget:

(A) Individuals

1. Lower PUB bills

Fixed charges in PUB bills, such as sanitary appliance fee, domestic refuse charge, rental for appliances and night soil removal fee, will no longer be included in the computation of the 10% tax.

2. No ceiling on CPF exemption

The S$5,000 tax exemption ceiling on CPF contributions will be removed. With effect from the 1983 year of assessment, all statutory CPF contributions and contributions to designated approved pension and provident funds will be fully tax deductible.

3. More relief for aged

The relief in respect of aged dependants will be raised from S$750 to S$1,000, allowable as long as each dependant has an income of no more than S$1,500 in the year.

4. Estate duty

(a) *Home ownership boost*
To promote home ownership, the estate duty exemption limit for one residential property will be raised from the present S$600,000 to the full value of that property and total estate duty exemption will be given on CPF balances.

(b) *Gold deposits*
Gold deposits with bullion companies held by foreigners, who are neither resident nor domiciled in Singapore, will not be liable to estate duty.

(B) Companies

1. Stamp duty
Stamp duty on ACU offshore loan agreements will be abolished with effect from 1 April 1980.

2. Road tax on buses
Road tax on buses irrespective of the size or engine capacity will be harmonised with effect from 1 April 1982.

3. Capital allowances
The ceiling of capital allowances on company registered cars will be raised from S$25,000 to S$35,000 with effect from 1 April 1982.

4. Liberalising of tax laws for leasing industry
Accelerated depreciation will be grated to the lessor on equipment leased to a lessee.

(C) Pensioners

Allowances to government pensioners now receiving gross pensions of less than S$850 a month will be raised.

(D) Non-industrial users of energy

Non-industrial users of energy will now be given accelerated depreciation allowances over 3 years for approved energy saving equipment. Hotels, restaurants, shopping complexes are among those who will qualify.

Tax Relief for Americans Abroad ~ An Overview ~

by Piroska E. Soos*

I. INTRODUCTION AND BACKGROUND

The general rule that United States citizens, regardless of residence, are subject to U.S. tax on their world-wide income could result in a substantial tax burden on those Americans who work abroad and are subject to foreign taxes. For many years, double taxation of such Americans has been at least partially avoided by providing tax relief in the form of exclusions, deductions or credits. Depending on the legislation in effect for a particular year, an individual could benefit simultaneously from more than one kind of relief, or he had to make an election.

The foreign earned income exclusion was first enacted in 1926 despite the objection that it was unnecessary because of the foreign tax credit available to expatriates, and after initial efforts to change or repeal it, the exclusion remained unmodified and unchallenged for several years.[1] The exclusion was designed to encourage Americans to engage in employment and other business activities abroad, and it was hoped that a greater U.S. presence abroad would increase U.S. exports.[2] As originally enacted, the exclusion was not intended to be a vehicle for reconciling the relative tax burdens of domestic and overseas taxpayers.[3]

At the time of its enactment, the exclusion was unlimited in amount and could be used by any U.S. citizen who had resided in a foreign country for six months or more.[4] The exclusion (based on residence) remained unlimited until 1962, and the changes made between 1926 and 1962 related to the eligibility requirements. In 1942, the six-month requirement was replaced by a bona fide residence test (see Section II), and in 1951, the exclusion was extended to U.S. citizens who did not satisfy the bona fide residence test but who were physically present in the foreign country for 17 out of 18 consecutive months. The reason for this change was to place U.S. citizens working abroad in an equal position with citizens of other countries going abroad who were not taxed by their own countries.[5] However, in 1953, because of abuses, a $20,000 per year limitation was placed on the exclusion for those who claimed it on the basis of the physical presence test.[6]

In 1962, the exclusion for bona fide residents was limited to $20,000 per year and to $35,000 per year for those who had been bona fide residents of a foreign country for at least three uninterrupted years. In 1964, the $35,000 exclusion was reduced to $25,000 per year.[7] At the time that these limits were set, they were high enough so that, for most individuals, all of their income (including allowances) fell within the exclusion.[8]

In addition to the exclusion, Americans abroad benefitted from two other rules. First, they could take the exclusion "from the top" of their gross income (not "exclusion with progression")[9] so that lower marginal rates applied to the income not exempt from U.S. tax. Secondly, foreign taxes paid on the excluded income were creditable against U.S. tax on any foreign income in excess of the exclusion.[10] Both of these rules have undergone changes since the Tax Reform Act of 1976.

Sweeping changes in the rules for the taxation of expatriates were made in 1976 and 1978, and the issue of an exclusion for expatriates was very controversial. The debates were intense, and the arguments for or against the exclusion, or tax relief in gerneral, were not always enlightening. For example, one U.S. Senator characterized U.S. citizens abroad as "mink-swathed Americans" who "spend their waking hours in gambling casinos in Monte Carlo" and as "high-living jetsetters living at the taxpayers' expense".[11]

Contents

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1. Slowinski, Walter A. and Williams, John B., "The Formative Years of the Foreign Source Earned Income Exclusion: Section 911", 51 *Taxes* 355, 357 (June 1973). This article is hereinafter cited as *Slowinski*.
2. Maiers, John D., "The Foreign Earned Income Exclusion: Reinventing The Wheel", *The Tax Lawyer*, Vol. 34, No. 3 (Spring 1981) at 692. This article is hereinafter cited as *Maiers*.
3. Bruce, Charles M., "New Rules Taxing Americans Working Abroad", 57 *Taxes* 79 (1979) (hereinafter *Bruce*).
4. *Slowinski*, at 356.
5. Id. at 358-359.
6. Id., at 359. the U.S. House Ways and Means Committee thought that some U.S. citizens were not paying any tax because they were not in any one country long enough to be classified as a resident for tax purposes. The Committee also thought that individuals with large earnings were going abroad to perform services, which they usually performed in the U.S., only to avoid U.S. income tax.
7. Id., at 360-362.
8. *Maiers* at 695.
9. Id., at 696.
10. Joint Committee on Taxation, *General Explanation of the Economic Recovery Tax Act of 1981* (hereinafter *General Explanation*), as reported in 1982 Prentice-Hall Federal Taxes, Report Bulletin 5, Vol. LXIII (Section 2), 14 January 1982, at 41.
11. Comments of Senator William Proxmire (Democrat from Wisconsin), *International Herald Tribune* of 12 December 1977, as reported in *U.S. Expatriate Taxation*, Vol. 2, No. 3 (September 1979) at 26.

Another opponent of tax relief for expatriates wrote that the "fact that expatriates who lobby for reduced taxation are always the best-dressed and only tanned people in the room may prejudice me".[12] It was also suggested that Americans abroad be required to pay the cost of maintaining consulates abroad; one response to this questioned the fairness of expatriates paying for consular officials whose preferred role is that of oppressors of overseas Americans.[13]

The Tax Reform Act of 1976[14] made substantial changes in the foreign earned income exclusion and in other aspects of expatriate taxation. The exclusion was reduced to $15,000 per year, although a $20,000 per year exclusion was permitted for employees of certain qualifying U.S. charitable organizations. In addition, foreign income taxes attributable to the excluded income were no longer eligible as a credit against U.S. tax. Finally, the 1976 Act introduced a rule that required that the exclusion come "off the bottom" ("exclusion with progression") of the taxpayer's gross income so that the top part was taxed at the marginal rate that would apply had there been no exclusion.[15]

As a result of angry protests by U.S. citizens working abroad, the effective date of the 1976 amendments was postponed until 1 January 1977, and later, it was postponed again until 1978 because of the inability of Members of Congress to reach agreement on the changes regarding the exclusion.[16] As a result of these postponements, the amendments made by the 1976 Act never went into general effect, although taxpayers could, for 1978, elect to be taxed under the provisions of either the 1976 Act or the Foreign Earned Income Act of 1978.[17]

This article will discuss the provisions of the Foreign Earned Income Act of 1978 and other provisions applicable to expatriates[18] just before the 1981 changes, which are effective for taxable years beginning after 31 December 1981. This article will also discuss the reasons for the 1981 changes and consider the revenue and other effects anticipated as a result of the new rules.

It should be noted that this discussion is limited to the provisions unilaterally provided by the U.S. and does not consider the numerous double taxation treaties, to which the U.S. is a party, that could affect a taxpayer's liability for either U.S. tax or foreign tax. It should further be noted, however, that U.S. citizens often do not benefit from treaties signed by the U.S. since many treaties contain a "savings clause" in which the U.S. reserves the right to tax its citizens and residents on the basis of all items of income taxable under its own revenue laws as though the treaty did not exist.[19]

II. THE FOREIGN EARNED INCOME EXCLUSION

A. Before the Economic Recovery Tax Act of 1981

The Foreign Earned Income Act of 1978 ("1978 Act")[20] virtually abolished the exclusion for most Americans working abroad and replaced it with a deduction for excess foreign living costs (see Section III). The 1978 Act did, however, retain a $20,000 annual exclusion for a small group of individuals, namely, those who resided in a camp located in a hardship area or who performed qualified charitable services in a lesser developed country.[21] Such individuals could elect the exclusion if they satisfied either the bona fide residence or physical presence test. If they satisfied either test for only part of the tax year, the $20,000 limit had to be prorated based on the number of days that the person satisfied the test relied upon. Individuals who elected the exclusion were not allowed the deduction for excess foreign living costs or the foreign tax credit (or deduction) for the taxes paid or accrued with regard to the excluded amount.[22]

For purposes of the exclusion, "camp" meant substandard housing which was (a) provided by or on behalf of the employer for the convenience of the employer because the place at which the individual rendered services was in a remote area where satisfactory housing was not available on the open market, (b) located, as near as practicable, in the vicinity of the place at which such an individual rendered services, and (c) furnished in a common area, or enclave, which was not available to the public and which normally accommodated 10 or more employees.[23] A hardship area meant any foreign place designated by the U.S. Secretary of State as a hardship post where extraordinarily difficult living conditions, notably unhealthful conditions, or excessive physical hardships existed, and for which a post differential of 15% or more would be provided to U.S. government employees.[24] The 1978 Act also defined "lesser developed countries" and "qualified charitable services".[25]

The hardship area camp exclusion was designed to alleviate some of the problems of American construction companies operating overseas. However, because of the restrictive definition of "camp", the exclusion had a very narrow application.[26] Independent contractors or self-employed persons could not qualify for the exclusion since the "camp" had to be provided by the employer.

12. Kingston, Charles I., "A Somewhat Different View", *The Tax Lawyer,* Vol. 34, No. 3 (Spring 1981) at 739.
13. Kaplan, Philip T., "U.S.: Taxation of Americans Working Abroad", *Intertax* (September 1981/9) at 338, 339, n. 4.
14. Public Law No. 94-455.
15. Tax Reform Act of 1976, Section 1011(b)(3), adding I.R.C. Section 911(d).
16. *Maiers,* at 700-701.
17. *General Explanation,* at 41.
18. This article does not consider the rules applicable to resident aliens in the U.S. or the taxation of foreign-source income derived by legal entities, such as corporations, partnerships, etc.
19. For example, see Article XIX of the Netherlands-U.S. Income Tax Treaty of 29 April 1948, as amended by Supplementary Convention of 30 December 1965; Article 22 of the France-U.S. Income Tax Treaty of 28 July 1967, as amended by the Protocols of 12 October 1970 and 24 November 1978; Article XV of the Income Tax Treaty between the Federal Republic of Germany of 22 July 1954, as amended by the Protocol of 17 September 1965.
20. Public Law No. 95--615.
21. U.S. Internal Revenue Code (hereinafter I.R.C.), Section 911(a), (c). Unless otherwise indicated, references to I.R.C., Sections 911 or 913 are references to those sections just prior to the amendments made by the Economic Tax Recovery Act of 1981.
22. I.R.C., Section 911(a).
23. I.R.C., Section 911(c)(1)(B).
24. I.R.C., Section 913(h).
25. I.R.C., Section 911(c)(1)(E) (lesser developed country); I.R.C., Section 911(c)(1)(D) (qualified charitable services).
26. *Maiers,* at 711.

An individual satisfied the bona fide residence test if he established to the satisfaction of the tax authorities that he had been a bona fide resident of a foreign country (or countries) for an uninterrupted period which included an entire taxable year.[27] Only a U.S. citizen could claim the exclusion on the basis of the bona fide residence test. Determination of bona fide residence was to be made by applying the principles of I.R.C., Section 871 (tax on non-resident alien individuals) and the regulations thereunder.[28] I.R.C., Regulation 1.871-2(b) defines "residence" as

> An alien actually present in the United States who is not a mere transient or sojourner is a resident of the 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.

The bona fide residence test was not satisfied if the individual gave a statement to the foreign authorities that he was not a resident of that country for purposes of the income tax of that country and he was held not subject, as a resident of that foreign country, to the income tax imposed by that country.[29] In Revenue Ruling 78-254,[30] the U.S. Internal Revenue Service ("I.R.S.") considered whether the taxpayers had made a "disqualifying" statement by filing non-resident tax returns in Belgium. The I.R.S. concluded that they had not, since the taxpayers had not made statements to the Belgian authorities that they were not "residents" of Belgium, as that term is defined for U.S. tax purposes.

The physical presence test could be used by both U.S. citizens and non-U.S. citizens to qualify for the exclusion, and the test required an individual to be present in a foreign country (or countries) for 510 days (approximately 17 months) out of a period of 18 consecutive months.[31] This test was objective and did not consider factors such as the kind of residence established, the nature and purpose of the individual's stay, or his intentions about returning to the foreign country. The test was concerned only with how long an individual was in one or more foreign countries. However, the requirement of 510 days within an 18 month period was unconditional (except as indicated below). An individual fell short of the requirement even if he was forced to leave the foreign country before satisfying the text because of illness or because he was ordered to leave.

As an exception, the 1978 Act permitted waiver of the bona fide residence test or physical presence test if three conditions were satisfied: (1) the individual was actually present in, or a bona fide resident of, a foreign country, (2) he left the country after 31 August 1978 during a period with respect to which the Treasury Department determined that individuals were required to leave the foreign country because of war, civil unrest, or similar adverse conditions in the foreign country which precluded the normal conduct of business by those individuals, and (3) the individual established to the satisfaction of the tax authorities that he reasonably could have expected to meet the time limitation requirements, but for the war, civil unrest, or similar adverse conditions.[32] If these criteria were met, the taxpayer was considered as having satisfied the bona fide residence test or physical presence test for the time that he was resident or present in the foreign country, and the exclusion was computed accordingly.

The exclusion was limited to the individual's "foreign earned income" derived during the time that satisfied either the bona fide residence test or the physical presence test.[33] For purposes of both the exclusion and the deduction for excess foreign living costs (see Section III), "earned income" meant wages, salaries, professional fees and other amounts received for personal services rendered,[34] and was considered received in the year in which the services were rendered.[35]

"Earned income" did not include amounts received as a pension or annuity[36] or that part of an individual's compensation for personal services rendered to a corporation which represented a distribution of profits rather than a reasonable allowance for compensation for the personal services actually rendered.[37] If an individual was engaged in a business (other than in corporate form) in which both personal services and capital were income-producing factors, "earned income" meant a reasonable allowance (not in excess of 30% of the individual's share of net profits) as compensation for the personal services rendered by the individual.[38]

For individuals who elected the exclusion, the hardship area camp was considered to be part of employer's business premises.[39] This meant that the individual could also exclude from gross income the value of employer provided meals and lodging under I.R.C., Section 119 (meals or lodging furnished for the convenience of the

27. I.R.C., Sections 911(a) and 913(a)(1).
28. I.R.C., Regulation 1.913-2(b).
29. I.R.C., Section 911(c)(6).
30. 1978-1 Cumulative Bulletin 243.
31. I.R.C., Section 913(a)(2).
32. I.R.C., Section 913(j)(4).
33. I.R.C., Section 911(a).
34. I.R.C., Section 911(b).
35. I.R.C., Section 911(c)(2). However, if the amount was received after the close of the taxable year following the taxable year in which the services (to which the amounts were attributable) were performed, the amount could not be excluded from gross income. I.R.C., Section 911(c)(4). This rule also applies to taxable years beginning after 31 December 1981. See New I.R.C., Section 911(b)(1)(B)(iv). "New I.R.C." refers to the provisions of the 1981 Act.
36. I.R.C., Section 911(c)(5).
37. I.R.C., Section 911(b).
38. Id.; I.R.C., Regulation 1.911-2(b).
39. I.R.C., Section 911(c)(7).

employer) if the other requirements of Section 119 were satisfied.[40]

B. Exclusions under the Economic Recovery Tax Act of 1981

The Economic Recovery Tax Act of 1981 ("1981 Act")[41] dramatically changed the exclusions available to Americans working abroad. The 1981 Act abolished the exclusions under the 1978 Act and established a new exclusion for foreign earned income. The 1981 Act also provided, on top of the foreign earned income exclusion, an exclusion for the "housing cost amount". For 1982, the maximum annual foreign earned income exclusion is \$75,000 and this amount is increased by \$5,000 per year until 1986, when the maximum annual exclusion will be \$95,000.[42] The dollar limit was placed on the exclusion in order to prevent abuse by highly paid entertainers or athletes who might otherwise move abroad to avoid U.S. tax on their income.[43] The earned income exclusion is computed on a daily basis for each day within the period of bona fide residence or physical presence in the foreign country and in case of a married couple, the exclusion is computed separately for each qualifying individual.[44] Significantly, the 1981 Act does not contain an "exclusion with progression" rule, so that the U.S. tax on non-excluded income is computed from the bottom of the U.S. rate scale.[45]

The exclusions are available on an optional basis, and an individual may elect either or both of them. The election may be made by individuals whose "tax home" is in a foreign country and who satisfy either the bona fide residence test or physical presence test.[46] "Tax home" is the individual's regular or principal place of business, employment, or post of duty regardless of where he has his residence; if the individual does not have a regular or principal place of business, his tax home is the place in which he regularly lives.[47] An individual is not considered to have a tax home in a foreign country for any period for which his abode is in the U.S.[48] Thus, an individual who lives in the U.S. but commutes daily to work in Canada has his tax home in the U.S.

The bona fide residence test is the same as it was under prior law and may be used only by U.S. citizens. The requirements for the physical presence test have been relaxed: an individual satisfies the test if he is physically present in one or more foreign countries for at least 330 days in a period of 12 consecutive months.[49] These tests may be waived, and the conditions for waiver are the same as under the 1978 Act.[50]

Other features of the prior law remained unchanged. The definition of "earned income" is the same as before,[51] and the income is taken into account in the taxable year in which the services to which the amounts are attributable are performed.[52] As under prior legislation, "double benefits" are denied: no deduction, exclusion from gross income or credit against tax (including the credit for foreign taxes) is allowed to the extent that the deduction, exclusion or credit is properly allocable to or chargeable against amounts excluded pursuant to the foreign earned income or housing exclusions.[53]

The housing exclusion permits an individual to exclude from gross income his "housing cost amount" which is equal to the excess of his "housing expenses" over the "base housing amount,"[54] and a qualifying individual may elect the housing exclusion whether or not he elects the foreign earned income exclusion. The housing exclusion applies to amounts "paid or incurred on behalf of the individual by the individual's employer which is foreign earned income included in the individual's gross income for the taxable year".[55] Individuals whose housing expenses are not "employer provided amounts" may take a deduction for their "housing cost amount". See Section III.B.

"Housing expenses" have the same definition as under the 1978 Act and include reasonable expenses (not lavish or extravagant under the circumstances) attributable to housing, such as rent, utilities, real and personal property insurance, local telephone charges, furniture rental, and parking fees.[56] "Housing expenses" do not include amounts deductible as interest or taxes, the cost of a home purchase, improvements or furniture purchases, domestic labor, principal mortgage payments or depreciation.[57] The "base housing amount" is 16% of the salary of a U.S. employee whose salary grade is step 1 of GS-14. Since that salary is currently \$39,689 per year, the "base housing" amount is \$6,350 per year.[58]

If an expatriate maintains more than one foreign household, only the one closest to his tax home is eligible for the housing exclusion. As an exception, the housing expenses of a second foreign household are also excludable if the individual's spouse and dependents live at the second household because of dangerous, unhealthful or otherwise adverse living conditions at the individual's residence.[59]

If an individual elects both the foreign earned income exclusion and the housing exclusion, the total amount of the two exclusions may not exceed the individual's

40. The other requirements for exclusion under Section 119 are that (1) the meals and lodging be provided for the employer's convenience, and (2) lodging be accepted by the taxpayer as a condition of his employment.
41. Public Law No. 97-34.
42. New I.R.C., Section 911(b).
43. *General Explanation,* at 43.
44. Id., at 44.
45. *Intertax,* at 341.
46. New I.R.C., Section 911(a), (d).
47. New I.R.C., Section 911(d); *Commissioner* v. *Flowers,* 326 U.S. 265 (1946).
48. I.R.C., Regulation 1.913-3(a). Although this regulation was promulgated under prior law, it is currently relevant because the definition of "tax home" is the same for purposes of the 1978 Act and the 1981 Act.
49. New I.R.C., Section 911(d).
50. New I.R.C., Section 911(d)(4).
51. *General Explanation,* at 44.
52. New I.R.C., Section 911(b)(2)(B).
53. New I.R.C., Section 911(d)(6).
54. New I.R.C., Section 911(c).
55. New I.R.C., Section 911(c)(3)(D).
56. See I.R.C Regulations 1.913-6(a) and (b) which provide more details as to what constitute "housing expenses".
57. Id.
58. *General Explanation,* at 45.
59. New I.R.C., Section 911(c). I.R.C., Regulation 1.913-3(b)(2) provides that adverse living conditions include a state of warfare or civil insurrection in the general area of the individual's tax home.

foreign earned income for the year.[60] For example, if an individual has, for 1982, a salary of $68,000 and the value of the employer provided housing is $10,000 for the year, his total earned income is $78,000 and his housing exclusion is $3,650 ($10,000 less $6,350). The first $75,000 of earned income may be excluded under the earned income exclusion, but only $3,000 of the housing exclusion may be used since the maximum exclusion is $78,000. If the individual's salary in this example were $70,000 per year, his total earned income would be $80,000. He would exclude $78,650 ($75,000 earned income exclusion plus $3,650 housing exclusion).

Once an individual elects the earned income exclusion or the housing exclusion, the election remains in effect for that year and all future years. Either election may be revoked with or without the consent of the I.R.S. However, if the election is revoked without such consent, the individual may not make another election until the sixth taxable year following the taxable year for which the revocation was made.[61]

The 1981 Act retained the rule that, for an individual who is furnished lodging in a camp located in a foreign country by his employer, the camp is considered to be part of the employer's business premises. The definition of "qualifying" camp was relaxed: it is no longer required that the camp be in a hardship area or that it constitute substandard lodging. Although the 1981 Act abolished the hardship area camp exclusion, this provision is important because it may enable individuals to exclude from gross income the value of employer provided meals and lodging under I.R.C., Section 119.

III. DEDUCTIONS FOR FOREIGN EXPENSES

A. Deductions under the 1978 Act

The 1978 Act replaced the exclusion available under prior legislation with a deduction from gross income for excess foreign living costs. The deduction was available to individuals who satisfied either the bona fide residence test or the physical presence test. The tests could be waived under certain circumstances (see Section II).

The maximum allowable deduction was the individual's "net foreign-source earned income", which was defined as the individual's earned income from sources outside the U.S. for that part of the taxable year in which his tax home was in a foreign country, reduced by (1) any foreign-source earned income which was excluded from gross income under I.R.C., Section 119 and (2) deductions (except for the deduction for excess foreign living costs) properly allocable to or chargeable against the foreign-source earned income for the part of the year during which the individual's tax home was in a foreign country.[62] This limitation precluded an individual from using his excess foreign living expenses to reduce taxable income from domestic sources or passive income from foreign sources. For purposes of the excess foreign living cost deduction, "tax home" had the same definition as it has for purposes of the exclusion under the 1981 Act.

For qualifying individuals, the deduction consisted of five separate items: (1) cost of living differential, (2) housing expenses, (3) schooling expenses, (4) home leave travel and (5) hardship area amount.[63] The cost of living differential was generally the amount by which the cost of living in the individual's foreign tax home exceeded the cost of living in the highest cost metropolitan area in the continental U.S., other than Alaska. The I.R.S. prepared tables for individuals to use to compute their cost of living differential, which was to be determined on a daily basis for the period during which the individual's tax home was in a foreign country. If an individual had more than one foreign tax home during the taxable year, he had to compute a separate cost of living differential for each foreign country.[64] An individual could not claim a cost of living differential for any day that the value of his meals and lodging were excluded from gross income under I.R.C., Section 119.[65]

Housing expenses were the excess of the individual's reasonable housing costs (see Section II.B.) over the "base housing amount" which was generally one-sixth of his net earned income.[66] The expenses to be taken into account were only those attributable to housing during periods for which the individual's tax home was in a foreign country and the value of his housing was not excluded under I.R.C., Section 119. Housing expenses also included the expenses for a qualified second household (for an individual's spouse or dependents) if the individual's tax home was in a hardship area camp or if the living conditions at his tax home were adverse. However, special rules applied for the computation of the deduction for excess living costs, including housing expenses, if the individual had a qualified second household.[67]

Schooling expenses consisted of the expenses incurred for the education of the taxpayer's dependents at elementary and secondary levels (equivalent to education from kindergarten through the 12th grade in a U.S.-type school). Expenses included the cost of tuition, books and local transportation; expenses also included the cost of room, board and travel if an adequate U.S.-type school[68] was not available within a reasonable commuting distance of the individual's tax home. Schooling expenses were deductible only if they were attributable to education for a period during which the individual's tax home was in a foreign country.[69]

The home leave travel expense included the cost of one round trip for the individual, his spouse, and dependents from his tax home outside the U.S. to his principal domestic residence. Only one round trip per person for each continuous period of 12 months for which the indi-

60. *General Explanation*, at 45-46.
61. New I.R.C., Section 911(e).
62. I.R.C., Section 913(c).
63. See I.R.C., Section 913(d), (e), (f), (g) and (h).
64. I.R.C., Regulation 1.913-5(c).
65. I.R.C., Section 913(d)(1)(E).
66. *General Explanation*, at 43. The method for calculating the "base housing amount" is set forth in I.R.C., Section 913(d).
67. See I.R.C., Section 913(i) and I.R.C., Regulations 1.913-5(e), 1.913-6(d), 1.913-7(f).
68. I.R.C., Regulation 1.913-7(e) provides that a U.S.-type is a school which offers a curriculum which is taught in English, is comparable to that offered by accredited schools in the U.S., and would qualify the student for graduation if he were to transfer to a U.S. school.
69. I.R.C., Section 913(f).

vidual's tax home was in a foreign country could be deducted.[70]

The hardship area deduction was $5,000 per year and available to those who lived in a hardship area (see Section II.A.). The amount available as a deduction was to be computed on a daily basis for each day that the individual's tax home was in a hardship area.[71]

An individual who claimed the deduction for excess foreign living costs could also claim the foreign tax credit (see Section IV). However, an individual could not claim the deduction if he elected the exclusion for income earned in a hardship area camp or from qualified charitable services or if his spouse claimed the exclusion, unless the spouse maintained a separate abode which was not within a reasonable commuting distance from the taxpayer's abode.[72]

B. Deductions under the 1981 Act

The 1981 Act repealed the excess foreign living cost deduction, and as a result, there are only two deductions specifically for Americans working abroad. However, Americans abroad may claim any deduction that is generally allowed to resident taxpayers, such as deductions for medical expenses, charitable contributions, and personal exemptions.

An expatriate may elect the housing deduction, introduced by the 1981 Act, which may be used for housing costs which are not attributable to employer provided amounts. The deduction is limited to the excess of the individual's foreign earned income for the taxable year over the amount excluded under the foreign earned income exclusion. There is a one year carryover (to the succeeding tax year) of housing costs not allowed as a deduction because of this limitation.[73]

The second deduction for Americans working abroad is the deduction for foreign taxes paid or accrued. With regard to some kinds of taxes, an individual may elect between a credit or deduction (see Section IV). However, some foreign taxes, such as foreign real property taxes,[74] do not qualify for the credit and may be taken only as a deduction.

IV. CREDIT FOR FOREIGN TAXES

The 1981 Act did not make any changes in the rules applicable to the credit for foreign taxes available to Americans working abroad. Nonetheless, the primary features of the credit will be briefly discussed because the credit is an important tool for reducing the tax burden of expatriates. The credit, which was first enacted in 1918,[75] is available whether or not the individual satisfies the bona fide residence test or physical presence test. In addition, the credit may be used in conjunction with the exclusions or deductions to the extent that the rule against "double benefits" is not violated.

The individual may choose between a credit or deduction for "income, war profits and excess profits" taxes[76] paid or accrued to a foreign country, or taxes paid or accrued in lieu thereof.[77] If the individual elects the credit, he must do so with all "qualifying" taxes; he may not use part of them as a credit and the balance as a deduction.[78] Taxes that do not qualify for the credit may be taken as a deduction. Some taxes, such as the value added tax, qualify for neither the credit nor the deduction.[79]

There is a limit to the amount of the foreign tax credit. It may not exceed the same proportion of the U.S. tax (against which the credit is taken) that the individual's taxable income from foreign sources (but not in excess of the individual's total taxable income) bears to his entire taxable income for the same year. In other words, the credit may not exceed the following fraction:

$$\text{Maximum credit} = \frac{\text{foreign taxable income}}{\text{total taxable income}} \times \text{U.S. tax liability.}$$

For purposes of this computation, "foreign taxable income" means the total foreign-source income reduced by deductions directly attributable to such income, as employee business expenses or (under the 1978 Act) the excess foreign living costs deduction.[80] This amount is further reduced by a portion of other deductions that are not directly attributable to foreign-source income, such as medical expenses and the standard deductrion (now called "zero bracket amount"). The total amount of these "indirect" deductions is multiplied by a fraction, the numerator of which is the total foreign-source income and the denominator of which is gross income from all sources. This amount is subtracted from foreign-source income, and the result is "foreign taxable income".

"Total taxable income" means "taxable income" as determined under U.S. tax laws, with certain adjustments. For U.S. tax purposes, "taxable income" is the individual's "adjusted gross income" less (1) the itemized deductions in excess of the standard deduction ("zero bracket amount") and (2) the amount deductible as personal exemptions.[81] For purposes of the foreign tax credit, "total taxable income" means "taxable income" reduced by the "zero bracket amount" but not by the personal exemptions.[82] Special rules apply for the treatment of capital gains[83] and for recapture of foreign losses.[84]

These rules ensure that U.S. citizens will always be liable for U.S. tax on their U.S. source income, regardless of the amount of foreign taxes paid. If the foreign taxes exceed the maximum allowable, the taxpayer may carry back the excess to the two prior taxable years and then carry forward the unused credit to the following five tax-

70. I.R.C., Section 913(g).
71. I.R.C., Section 913(h).
72. I.R.C., Regulation 1.913-2(a).
73. New I.R.C., Section 911(c)(3).
74. I.R.C., Section 164.
75. Williams, Thomas J., "The Creditability of Foreign Income Taxes: An Overview", 58 *Taxes* 699 (October 1980) at 700.
76. I.R.C., Section 901(b).
77. I.R.C., Section 903.
78. I.R.C., Regulation 1.901-1(c).
79. See I.R.C., Section 164(a)(4) and *Intertax*, at 341, n. 11.
80. I.R.C., Regulation 1.913-1(b).
81. I.R.C., Section 63.
82. I.R.C., Section 904.
83. I.R.C., Section 904(b).
84. I.R.C., Section 904(f).

able years. However, the excess foreign taxes may be used in other years only to the extent that, in that other year, the taxpayer had an unused foreign tax credit allowance, i.e. the "qualifying" taxes for that year were less than the maximum allowable as a credit. An unused credit may not be taken as a deduction in other years.[85]

A major problem with the foreign tax credit has been the confusion regarding the meaning of "income tax". Although the I.R.S. has issued regulations defining the term,[86] the matter is not resolved, and the complexity and difficulty of this area is indicated, among other things, by the fact that the regulations contain over seventy examples illustrating the various standards for creditability. The U.S. Government's awareness of this problem is indicated by a recent letter to Senator Charles H. Percy, Chairman of the U.S. Foreign Relations Committee, in which Senate Finance Committee Chairman Robert Dole wrote that:

> *The question of what foreign taxes are creditable against U.S. tax has, for several years now, been the subject of substantial controversy. Several versions of the section 901 regulations that have been proposed have been subjected to substantial criticism by affected taxpayers.*
>
> *Some taxpayers maintain that the regulations adopt an overly restrictive interpretation of the statute so that the credit issue may be preserved for treaty negotiations. Taxpayers also complain that requests for IRS rulings receive no action and suspect similar motives to explain the IRS inaction.*
>
> *I am sympathetic with the plight of taxpayers who do not know whether the foreign tax they pay is creditable . . . .*[87]

The foreign tax credit may not be used to offset certain U.S. taxes,[88] and the amount of foreign taxes that qualify for the credit may be decreased if the taxpayer participates in or cooperates with an international boycott.[89]

V. REASONS FOR CHANGE AND ANTICIPATED EFFECTS

The primary reason for the 1981 changes had to do with U.S. economic and trade policy and the concern over continuing deficits by the U.S.[90] Generally, it is more expensive for U.S. companies to utilize Americans rather than nationals in their foreign operations, since the companies commonly have "tax equalization" plans and provide special allowances to their overseas employees. A tax executive of a N.Y. corporation said that the current cost of supporting an American with an annual salary of $30,000 in a foreign country was about $120,000, including salary, housing, education, home leave and taxes.[91]

The extra cost of employing Americans overseas resulted in either (1) higher prices to the customer or (2) replacement of Americans by foreign nationals, or both. To the extent that U.S. businesses charged higher prices, they became less competitive, and this led to noncompetitive bids in intensely competitive industries such as construction.[92] One survey indicated that the cost of maintaining American workers overseas added 2 to 10%, depending on the industry, to the cost of U.S. goods and services, and construction firms included in the survey reported that they lost at least 1.2 billion in sales in 1979 because of the increased tax burden on overseas employment.[93]

As to the replacement of Americans by foreign nationals, an executive of a U.S. company estimated that the number of Americans working overseas in such highly skilled professions as construction, architecture, and design declined by about 50% in 1979.[94] The replacement of Americans by foreign nationals was considered to have an adverse effect on U.S. exports. Foreign nationals often ordered parts and equipment from their own countries[95] because they were more familiar with the products and standards of their own country and because they considered the maintenance of business contacts with their home countries as being in their individual interests. It was estimated that U.S. exports in 1980 were 5% below what they could have been because of the decrease in the number of Americans working abroad.[96] A U.S. government study indicated that a 1% decrease in the number of Americans abroad results in a 0.5% decline in the value of U.S. exports.[97]

The 1981 changes are designed to reverse this situation by making it less expensive to employ Americans abroad. U.S. companies generally agree that the lower cost will increase U.S. competitiveness for foreign contracts and indirectly increase U.S. exports.[98]

However, there is disagreement as to the effect of the 1981 Act on the employment of Americans abroad. Some indications are that the lower cost of supporting Americans abroad will be translated into more overseas jobs being filled by Americans.[99] Others disagree. U.S. companies started substituting foreign nationals because of the burdensome tax law changes in 1976 and 1978. But the shift to foreign nationals made sense for other reasons – they know the language, market conditions, and economy better than someone brought in from the outside.[100]

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85. I.R.C., Regulation 1.904-2(a).
86. I.R.C., Regulation 4.901-2).
87. The text of the letter was reproduced in *Tax Notes*, Vol. XIII, No. 17, 26 October 1981, at 1005-1007.
88. The foreign tax credit may not be used against the tax imposed by Section 56 (minimum tax for tax preferences), by Section 72(m)(5)(B) (10% tax on premature distributions to owner-employees), by Section 402(e) (tax on lump sum distributions), by Section 408(f) (additional tax on income from certain retirement accounts), by Section 531 (tax on accumulated earnings), by Section 1351 (recoveries of foreign expropriation losses) or by Section 541 (personal holding company tax). See I.R.C., Section 901.
89. I.R.C., Section 908.
90. *General Explanation*, at 43.
91. "Gains for Americans Who Work Abroad", *New York Times*, 28 August 1981 (hereinafter *New York Times*).
92. *General Explanation*, at 43.
93. *Maiers*, at 720.
94. "Tax Break Not Seen Causing Rush of Americans Overseas", *Asian Wall Street Journal*, 27 August 1981 (hereinafter *Asian Wall Street Journal*).
95. *General Explanation*, at 43.
96. *Asian Wall Street Journal*.
97. *Bruce*, at 80.
98. *Asian Wall Street Journal*.
99. *New York Times*.
100. *Asian Wall Street Journal*.

As to the other effects of the 1981 changes, it is expected that the new provisions will eliminate the U.S. tax liability for about 90% of U.S. citizens working abroad.[101] However, since most major U.S. companies pay for the extra tax burden, they will benefit from the new provisions. A Citibank executive noted that the bank had picked up the tax burden and will also pick up the benefit.[102] A U.S. expatriate working for Arabian American Oil Company made the same observation: because of the company's policies, the 1981 Act would have no effect on his net income.[103]

As a result of the 1981 Act, the U.S. Government expects the fiscal year tax receipts to decrease by $299 million in 1982, by $544 million in 1983, by $563 million in 1984, by $618 million in 1985, and by $696 million in 1986.[104]

101. "Reagan Signs Bill on Taxes Abroad", *International Herald Tribune*, 14 August 1981.
102. *New York Times.*
103. *Tax Notes,* Vol. XIV, No. 3, 18 January 1982.
104. *General Explanation,* at 48.

Conference Diary

JUNE 1982

Shang York SA: Doing business with the People's Republic of China (including: past experience; present industrial policy; recent tax laws and regulations concerning foreign investment). Geneva (Switzerland), June 14 (English).

Oyez International Business Communications Limited: International Tax (including: U.K. law and double taxation; elements of international tax planning; common provisions in U.K. treaties; the practical use of tax conventions) followed by a choice of specialised half day programmes on U.S.A., France, Germany, Italy, Switzerland, the Netherlands and Norway. London (United Kingdom), June 14-16 (English).

European Study Conferences Group and Convention Services: International Tax Planning: Maximising Protection of Investments and Assets (including: tax pitfalls and opportunities of emergency measures). Miami (U.S.A.), June 15 and 16 (English).

European Study Conferences Group and Convention Services: International Oil and Gas Taxation Conference (including: Oil and gas taxation in China, Denmark, U.K. Norway, Canada and the U.S.A. Houston (U.S.A.), June 17 and 18 (English).

Practising Law Institute: Real estate syndications (including: Special problems of foreign investors; The non-resident alien individual partner). New York City (U.S.A.), June 17-18 (English).

Georgetown University Law Center: The Fourth Annual Institute on Multinational Taxation (including: Current developments in international tax rules outside the U.S.; Tax treaties – the changing landscape). Washington, D.C., (U.S.A.), June 24-25 (English).

JULY 1982

Practising Law Institue: International estate planning (including: Taxation of non-resident alien in the U.S.; The use of foreign situs trusts). New York City (U.S.A.), July 22-23 (English).

SEPTEMBER 1982

36th Annual Congress of I.F.A.: I. The tax treatment of interest in international economic transactions. II. Taxation of payments to non-residents for independent personal services. Montreal (Canada), September 12-16 (English, French, German, Spanish).

Confédération Fiscale Européenne (C.F.E.): Third European Congress of Tax Consultants (including: State of tax harmonisation in Europe; The application of wealth taxes and taxes arising on death to foreign assets and liabilities; The practical application of international tax provisions (working groups)). Aachen (Germany), September 30 to October 2 (English, French, German).

OCTOBER 1983

37th Annual Congress of I.F.A.: I. Tax avoidance/tax evasion. II. International problems in the field of turnover taxation. Venice (Italy), October 10-15 (English, French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

Confédération Fiscale Européenne (C.F.E.): Secrétariat Général, Postfach 1340, Dechenstrasse 14, D-5300 Bonn 1 (Federal Republic of Germany).

European Study Conferences Group and Convention Services: 2616 South Loop West, Suite 330, Houston, Texas 77054 (U.S.A.).

Georgetown University Law Center: 600 New Jersey Avenue, N.W. Washington, D.C. 20001 (U.S.A.).

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

Oyez International Business Communications Limited: Norwich House, Norwich Street, London EC4A IAB (United Kingdom).

Practising Law Institute: 810 Seventh Avenue, New York, N.Y. 10019. (U.S.A.).

Shang York S.A.: 56 rue du Stand, CH-1204 Geneva (Switzerland).

UNITED STATES:

EXCHANGE OF INFORMATION*

Disclosure to Foreign Countries Pursuant to Tax Treaties

(25)10 (2-12-82)

GENERAL

(1) The United States has entered into tax treaties with foreign countries primarily to alleviate double taxation and to help identify fraud and tax evasion through exchange of information. Although the majority of treaties cover exchange of information concerning income taxes, there are also treaties covering the exchange of information concerning estate and gift taxes.

(2) IRC 6103(k)(4) of the Internal Revenue Code provides for disclosure of information with foreign countries. This subsection provides that: "A return or return information may be disclosed to a competent authority of a foreign government which has an income tax or gift and estate tax convention or other convention relating to the exchange of tax information, with the United States but only to the extent provided in, and subject to the terms and conditions of, such convention."

(3) Tax treaties generally provide for exchange of information between the IRS and foreign tax authorities. Individuals referred to as "Competent Authorities" are designated by each country to make written requests for information and to receive information.

(4) The U.S. "Competent Authority" is the Assistant Commissioner (Compliance). However, under Compliance Order 14, the authority to act as U.S. Competent Authority was redelegated to the:

(a) Director, Examination Division, for administering the Simultaneous Examination Program, Spontaneous Exchanges of Information, and Industrywide Exchanges of Information, under the exchange of information provisions of the Income Tax Treaties to which the United States is a partner; and

(b) Director of International Operations, for administering the Programs for Routine and Specific Exchanges of Information and the Program for Mutual Assistance in Collection, under the Income Tax Treaties and Estate/Gift Tax Treaties to which the United States is a partner.

(5) Although the purpose of the redelegation is to allow routine competent authority correspondence to be signed at the Division level, the Assistance Commissioner (Compliance) will sign all correspondence involving sensitive or substantive policy matters.

(6) Copies of competent authority correspondence generated by the Examination function with respect to programs it is responsible for will be furnished to the Director of International Operations.

(25)20 (2-12-82)

INFORMATION RECEIVED FROM FOREIGN TAX AUTHORITIES

(1) If the IRS[1] needs information from a country with which the United States has a tax treaty, a request is submitted through channels for necessary action. Generally, OIO[2] reviews the request and, as appropriate, prepares a letter of request for the signature of the Director, OIO to be sent to the foreign tax authority.

(2) For U.S. requests pertaining to the Simultaneous Examination Program or an Industrywide Exchange of Information, the Director, Examination Division, will forward the request to the treaty partner competent authority upon receipt from the field.

(3) For Spontaneous Exchanges of Information, the Director, Examination Division, will forward foreign-initiated exchanges to the Assistant Regional Commissioner (Examination) for transmittal to the applicable District Director.

(4) Information which is received by the IRS from a foreign tax authority is subject to secrecy clauses contained in the specific tax treaty. In general, these secrecy clauses provide that information received by the IRS cannot be disclosed to any persons other than those (including courts and administrative bodies) concerned with the assessment, collection, enforcement or prosecution with respect to the taxes, which are the subject of the respective tax treaties. Additionally, to the extent the information relates to the liability or possible liability for tax of a United States taxpayer or otherwise falls within the definition of return information in IRC 6103(b)(2), it is return information subject to the restrictions on disclosure imposed by IRC 6103 as well as the restrictions contained in the treaty clauses.

(5) Because of the secrecy clauses, tax treaty information may not be disclosed to State tax agencies under IRC 6103(d), the Department of Justice or other Federal agencies under IRC 6103(i), or under any other provision of IRC 6103 permitting disclosure for non-Federal tax administration purposes.

(6) Disclosure Officers should ensure that information disclosed for non-Federal tax administration purposes is reviewed and tax treaty information is removed prior to

* Chapter (25)00: "Disclosure to Foreign Countries pursuant to tax treaties" from the *Disclosure of Information Handbook*.

1. Internal Revenue Service.
2. Office of International Operations.

disclosure. Information obtained under a tax treaty is often stamped to indicate that it is tax treaty information.

(7) Generally, tax treaty information obtained from a foreign tax authority may be disclosed to the United States taxpayer to whom it relates in accordance with IRC 6103(e). In this situation, the taxpayer is considered to be concerned with assessment, collection, enforcement or prosecution with respect to the taxes which are the subject of the tax treaty. However, disclosure will not be made to the taxpayer if the IRS or the foreign tax authority providing the information objects to disclosure or if disclosure would seriously impair Federal tax administration. (See IRC 6103(e)(7).)

(8) If a Freedom of Information Act request for tax treaty information is received, the procedure in text (13)46 of this Handbook should be followed.

(25)30 (2-12-82)

DISCLOSURE OF INFORMATION TO FOREIGN TAX AUTHORITIES

(1) If information is needed by a foreign country with which the United States has a tax treaty, a request is submitted by the Competent Authority to the U.S. Competent Authority. Exchanges of information by the IRS with foreign tax authorities are authorized in the National Office by the Director, OIO or Director, Examination Division, or the Assistant Commissioner (Compliance) for sensitive cases. Certain automatic or "routine" exchanges (such as transmission of reports of taxes withheld from income paid to non-resident aliens) are accomplished at the Philadelphia Service Center.

(2) The Director, OIO generally forwards requests for information to the appropriate IRS offices. When the requested information is received from the IRS offices, OIO prepares a response for the signature of the Director, OIO transmitting the information to the foreign Competent Authority.

(3) For treaty partner requests pertaining to the Simultaneous Examination Program or Industrywide Exchange of Information, the Director, Examination Division, or the Assistant Commissioner (Compliance) in sensitive cases, will:
(a) forward the request to the District Director for action; and
(b) when the information is received, transmit it to the treaty partner competent authority.

(4) For Spontaneous Exchanges of Information, the Director, Examination Division, or the Assistant Commissioner (Compliance) in sensitive cases, will forward a U.S.-initiated exchange to the treaty partner competent authority.

(5) Generally, returns are not furnished to foreign tax authorities pursuant to tax treaties.

(6) If it should become necessary to issue a summons to obtain the requested information, the summons should be prepared and forwarded to District Counsel, OIO for review prior to issuance.

(7) Return information which could identify or tend to identify a confidential informant, or seriously impair an IRS tax investigation is generally not disclosed to foreign tax authorities.

(8) Information which would reveal business or trade secrets is excepted from the exchange of information provisions of the treaties.

(9) Disclosures to foreign tax authorities made pursuant to tax treaties must be accounted for in accordance with IRC 6103(p)(3) and the Privacy Act of 1974. See Chapter (38)00 of this Handbook for further information.

(25)40 (2-12-82)

NONTREATY DISCLOSURES TO FOREIGN COUNTRIES

(1) Although IRC 6103(k)(4) is generally the authority for disclosure of return information to foreign tax authorities, other provisions of IRC 6103 permit limited disclosures to foreign countries or individuals of foreign countries in certain situations. These disclosures can be made regardless of whether the United States has a tax treaty with the country. However, when a tax treaty is in effect, we exchange information under the treaty to the extent possible.

(2) Return information may be disclosed by IRS employees to individuals of foreign countries in accordance with IRC 6103(k)(6). See chapter (21)00 of this Handbook.

(3) Returns and return information may also be disclosed to individuals of foreign countries designated in writing by a United States taxpayer to receive such information in accordance with IRC 6103(c) and (e). For example, pursuant to a written taxpayer request and consent for disclosure, IRS may certify to a tax treaty country that taxes were paid in the United States to enable the taxpayer to receive credit for the taxes on a foreign return.

TAXATION OF FOREIGN BUSINESS ACTIVITIES IN AUSTRIA

by Prof. Dr. Wolfgang Gassner*
and Geoffrey C. Pink**

INTRODUCTION

Geographical convenience has resulted in Austria's importance as one of the foremost financial centres for East-West trade, and commercial transactions with Eastern bloc countries frequently begin and end in Austria. Accordingly, many firms have established branches or subsidiary companies there in order to do business with the Comecon, Yugoslavia and Albania; the activities would typically include marketing and maintenance of products sold in those countries, or perhaps a simple representative office. In either case the implications of Austrian tax are important when contemplating commercial contracts, and the following brief survey discusses aspects of the Austrian tax system which are relevant for foreign companies embarking on business relations with Austria.

I. THE AUSTRIAN TAXATION SYSTEM

1. Corporation tax on income of foreign companies from permanent establishments

Although the corporation tax is chargeable on income of all companies, those which are incorporated abroad and have their effective management outside Austria are only subject to limited taxation on certain income derived from Austrian sources. This limited tax liability applies above all to income from business for which a "permanent establishment" exists in Austria; this concept is defined in the Federal Tax Code (Bundesabgabenordnung) and resembles the OECD model treaty definition. A permanent establishment is any fixed place of business, and in particular a branch or a factory. The extent of liability may be reduced if the foreign company is resident in a country which has concluded a double taxation convention with Austria.

Corporation tax is charged on the income attributed to a permanent establishment for each calendar year. In arriving at this income, normal overheads are deductible, together with a number of investment incentives; for example, the accelerated depreciation can be made use of at annually varying rates from the costs of depreciable fixed assets. An accelerated depreciation is possible in the year of purchase in addition to the normal depreciation. Alternatively, an investment allowance of 10 to 20% of the cost of depreciable assets may be given in which case the total allowances are increased to 110 - 120% of the cost. A reasonable proportion of head office expenses may be charged to the permanent establishment and transactions between head office and the Austrian branch are generally to be treated on an arm's length basis.

Income from the permanent establishment is subject to corporation tax at the following tax rates:

Income (AS)	*Rate*
to 200,000	30%
200,100 - 250,000	30% + 50% on excess over 200,100
250,100 - 400,000	40%
400,100 - 500,000	40% + 50% on excess over 400,000
500,100 - 1,000,000	50%
1,000,100 - 1,142,800	50% + 40% on excess over 1,000,000
over 1,142,800	55%

Note: These rates are applied not to individual income brackets, but to total income.

2. Corporation tax of foreign companies on other source income

Apart from the income derived from an Austrian permanent establishment, other Austrian source income of foreign companies is subject to limited corporation tax. This tax as a rule is levied in the form of a 20% withholding tax, which may be reduced or omitted under the respective tax treaty. The following source income has to fall within this category:

(a) dividends of Austrian companies;
(b) compensation received by the company for the services of writers, speakers, artists, architects, athletes or entertainers of all kinds becoming active in Austria;
(c) royalty payments;
(d) compensation for consulting activities performed in Austria in the field of business administration or technology and for the supply of gangs for work in Austria.

3. Corporation tax of Austrian companies

If, however, a foreign company is doing business in Austria through a company incorporated in Austria, or having its management there, the latter is subject to unlimited corporation tax liability on its world-wide income. Business transactions with the parent company should be carried out on an arm's length basis in order to avoid hidden distributions of profit, which may entail considerable tax burdens. The taxable income of Austrian subsidiaries is assessed according to the same principles as that of permanent establishments set out above. However, the rates of tax on distributed profits are reduced by half by virtue of the "split corporation tax rate" that is in force in Austria. A 20% withholding tax is levied on dividends and royalty payments to the non-resident parent company, although this may be reduced under the respective tax treaty.

* Binder Dijker Otto & Co., BDO, Vienna.
** Binder Dijker Otto & Co., BDO, London.

4. Net wealth taxes, business taxes

Both Austrian branches and subsidiaries of non-resident companies are furthermore subject to net wealth tax. The tax of 1% is levied on the value of the Austrian assets of a branch or on the world-wide assets of an Austrian subsidiary, although the relevant tax treaty may mitigate this. In addition, there is a surtax of 0.5% (inheritance tax equivalent). If and insofar as individuals participate in the company this surtax may be eliminated under double tax treaties.

A business tax is also payable by Austrian permanent establishments of domestic or foreign companies. This is a three-part tax based on business profits, business capital and payroll. The business profit tax is levied together with the business capital tax, and amounts to approximately 14.5% of the business profit prior to deduction of the business profit tax as a business expense. The computation of the business profit is based on the profit determined for corporation tax purposes subject to certain additions and deductions. The most important addition is interest on long-term loans, while the most important deductions include 3% of the value of real estate, and profits from participations. The business capital tax amounts to approximately 0.35% of the business capital value adjusted by additions and deductions. The business tax on the payroll amounts to approximately 2% of the salaries and wages.

5. VAT

VAT is levied on goods and other services, as well as the self-consumption by companies, and the import of goods. The tax rates are 18% (standard rate), 8% (reduced rate), 13% (rate for energy) and 30% (rate for luxuries). The reduced rate of 8% is in particular applied to turnovers of basic foodstuffs, to the leasing of real estate, and to services from certain professional activities (medical doctors, lawyers, accountants, architects, etc.). The 13% tax rate relates to coal, fuel oil, gas, electricity and heat. A 30% VAT is, above all, levied on motor vehicles and on other luxury articles. In a series of businesses the turnover tax is of a purely transitory nature since input VAT can be claimed as a credit. Such a deduction of previously paid VAT is, however, not permissible in the case of private motor vehicles.

Foreign enterprises with neither their domicile or usual place of abode, nor seat or a permanent establishment in Austria, may claim tax exemption for their turnover and not apply VAT as long as they do not make use of the tax credit. In the case of delivery and installation of goods by a foreign enterprise, the material components may be accounted for separately. With regard to the VAT on imports, the credit for VAT may be claimed by the recipient of goods or services, but in all other cases of sales by foreign companies the VAT is withheld by the recipient of goods or services and paid to the tax office, where refunds of VAT may also be claimed by foreign enterprises under certain conditions.

6. Fees

A special peculiarity of the Austrian tax legislation are the fees according to the Fees Law (Gebührengesetz). Under the Fees Law certain documents and legal transactions and, in particular, requests to authorities are subject to fees payable in the form of inland tax stamps. Furthermore, a tax is payable on various legal transactions, such as lease or loan contracts, mortgage or credit contracts and cessions, if they are attested by a written document. As a rule the fee ranges between 0.8% and 2% of the value. The fee on legal transactions is usually exempted whenever a foreign company with no permanent establishment in Austria takes part in the transaction and, moreover, the contract is drawn up abroad and also remains there. The Fees Law is quite formalistic in nature and particularly complicated if foreigners are involved.

II. MAJOR CONTRACTS

Following this brief survey of the Austrian tax system, let us discuss the tax aspects of certain contracts that are important for foreign companies.

1. Supplier contracts

With respect to supplier contracts of foreign companies questions of taxation rarely arise. The foreign supplier is not liable to taxation in Austria as long as he does not maintain a permanent establishment there.

If he delivers the goods from local warehouses, these are not considered as permanent establishments according to the tax treaties. Under such circumstances, however, the foreign supplier becomes liable to pay VAT. VAT must be charged on sales and paid to the tax office and offset by previously paid VAT, in particular, for imports. In the sales contract it should be laid down that the VAT, which is to be shown separately in the invoices, increases the price. Without such specific mention any price agreed upon is understood as the gross price including VAT according to court rulings, so that the supplier receives an amount less VAT.

If an agent is used, care has to be taken that he does not constitute a permanent establishment of the foreign company in Austria. According to the tax treaties a dependent agent generally gives rise to a permanent establishment only if he is given power to conclude contracts. An independent agent may also bring into existence a permanent establishment of the foreign company, if his activities exceed the usual scope. The avoidance of a permanent establishment is important since it entails tax liabilities of the foreign company for the activities of the agent in Austria. The remuneration of an agent for the foreign company is not subject to the Austrian VAT.

2. Supplier, production and service contracts of branches

Supplier contracts carried out via an Austrian branch of the foreign company will normally give rise to a permanent establishment. The same applies to production and services undertaken by Austrian branches. As mentioned earlier, the creation of a permanent establishment entails limited tax liability for taxes on income and net wealth, as well as business tax liability. The profits of the permanent establishment from its business activities in Austria are therefore subject to corporation tax at the full rate and to business tax on the business profit. Where profits exceed 1,142,800 AS the tax burden amounts to approximately 62%. In addition, the assets of the branch are subjected to net wealth tax, the inheritance tax equivalent and the business capital tax amounting to a total of approximately up to 1.9%, and the salaries and wages are subjected to the payroll tax of 2%.

Contracts between the branch and third parties are under the unlimited jurisdiction of the Fees Law. Thus, in particular, loan contracts with banks or lease contracts for buildings or equipment and machinery are subject to fees. However, contracts between the branch and parent company are not liable to fees, since the branch is not itself a legal entity.

3. Formation of subsidiaries, partnerships and acquisition of participations

The formation of subsidiaries attracts a 2% company tax on the paid-in capital. In addition, court and notarial fees become payable. The company is subject to unlimited corporation and property taxes as well as to inheritance tax equivalent and business tax liability. For distributed profits the corporation tax is reduced by one half as already mentioned. The 20% withholding tax on the dividends is, as a rule, considerably reduced under the tax treaties and is credited against the foreign taxes of the parent company. For this reason, a tax advantage may sometimes be achieved by the organisation of subsidiaries instead of branches. The conversion of branches into subsidiaries is tax exempt by virtue of the Business Structure Improvement Law. With respect to fees, however, it should be noted that contracts between the parent company and the subsidiary (in contrast to those between headquarters and branch) may result in fees for legal transactions. This holds true, in particular, for loans by the parent company.

The formation of partnerships, with an Austrian partner, leads to a 2% legal transaction fee on the capital. A foreign company with a share in the partnership is subject to limited taxation like a permanent establishment according to the Corporation Tax Law, the Net Wealth Law and the Inheritance Tax Equivalent Law, and the profit shares are subject to business tax as in the case of a permanent establishment. As regards fees, the same regulations as for a subsidiary apply.

The acquisition of participations in limited liability companies attracts a 2% legal transaction fee and 0.5% stock exchange tax which may, however, be avoided or considerably reduced by a complicated make-up of the contracts.

For participations in stock companies, opnly a negligible stock exchange tax is payable. Participations in partnerships give rise to a 2% legal transaction fee. A revaluation of the tax depreciation basis in Austria is only undertaken in the event of acquisition of a participation in a partnership or the acquisition of a business, but not on the acquisition of participations in a company.

4. Building and construction contracts

Building and construction activities carried out in Austria by a foreign company lead to a permanent establishment only after a certain period of time; as a rule this period amounts to 12 months according to the tax treaties. In the case of shorter periods, generally only VAT becomes payable for which, however, exemption may be claimed, unless considerable VAT has accumulated, making the payment of the VAT and claim of the credit advisable. If the 12-month period is exceeded and a permanent establishment is brought into being, liability for corporation tax, net wealth tax, inheritance tax equivalent and business tax results, as in the case of a branch.

These principles also apply to the employment of subcontractors on the construction site. If the time limit is exceeded, each foreign sub-contractor separately gives rise to a permanent establishment and is individually liable to taxation. The general contractor employing subcontractors becomes liable to taxation as a permanent establishment only if his personal engagement on the construction site goes beyond mere supervisory functions of the sub-contractors. Where the building and construction activities are carried out by a consortium, the latter is treated as a partnership, if the consortium as such enters into contracts. The foreign partner of this consortium is subject to limited taxation in Austria on his share in the profit and the assets. If, however, the consortium only applies to the internal relationship of the partners and the commission is proportionally distributed among the partners, the foreign partner is only liable to limited taxation in respect of the profit and assets of his own permanent establishment.

5. Transfer prices, royalties, cost allocation

In all contracts with Austrian subsidiaries and permanent establishments the principles of dealing at arm's length have to be observed. For this reason the transfer prices for goods and services between the Austrian company or permanent establishment and the parent company or headquarters respectively have to be fixed at an adequate level, as between unrelated parties. This applies, in particular, to goods and services of the Austrian company or permanent establishment, since a hidden distribution of profits may be assumed otherwise.

Royalties are permitted for patents, trade marks and know-how. The amount accepted for tax purposes depends on their value to the Austrian enterprise. In various industries certain rates have in practice evolved from experience; in important cases it is advisable to seek agreement with the tax authorities. From the royalty payments of an Austrian subsidiary or partnership a 20% tax is withheld at source which may, however, be considerably reduced under the tax treaties and for which a foreign tax credit is granted in most cases. In concluding a contract it should be recognised that a 1% legal transaction fee may become payable, if the contract is concluded in Austria.

Cost allocations are permissible, if certain prerequisites are met: the costs have to be correctly ascertained at the parent company or the head office; the respective flow of products or services to the Austrian subsidiary or permanent establishment has to be proven; an adequate allocation basis has to be chosen, and an accounting control has to be installed. The opinion of a foreign accountant is accepted as a rule and the cost allocation itself may be negotiated with the tax authority.

6. Cost-plus contracts with East-West trading companies

As mentioned earlier, many foreign-owned subsidiaries have been set up in Austria for the purpose of doing business with East European countries and for serving the maintenance or marketing of products in those countries. Frequently representative offices in the Eastern countries are also maintained by these companies in order to benefit from the treaties of Austria with these countries and at the same time avoid their tax burdens.

Cost-plus contracts, which are basically accepted by the fiscal authorities, have become popular for such companies for reasons of simplification of the tax computation and for eliminating taxation of the full profit margins of the foreign companies in Austria. The Austrian subsidiary performs the representation, maintenance or marketing activities for the foreign parent company in return for remuneration in the amount of its expenses plus a small mark-up. These cost-plus contracts represent a major financial impetus for foreign companies to set up subsidiaries in Austria for doing business with the Eastern European countries.

REPUBLIC OF IRELAND:

Budget 1982

Extracts from the Budget Speech pronounced on 26 March 1982 by the Tanaiste and Minister for Finance Mr. MacSharry

It is unusual, to say the least, for two Budgets to be introduced in Dail Eireann within two months of each other. This fact alone makes it inescapable that this Budget will, in many respects, be similar to that which was presented on January 27th last. In the fortnight available to me, however, I have tried to ensure that while the principal objectives of that Budget – to reduce the current Budget deficit and the overall Exchequer borrowing requirement – will be met, my budget will help those least able to bear hardship and will achieve its aims in a far less disruptive way. Some of my excise taxation proposals have already been implemented and I shall be asking the Dail to confirm these today.

. . .

Tax proposals

I now turn to the question of taxation. I propose to implement the tax proposals put forward in January, subject to certain changes which I will shortly outline. It would not be practicable at this late stage to prepare an alternative tax package for 1982. Before indicating the details of the tax measures, however, I think it necessary to emphasise that our present taxation structure places severe constraints on the freedom of manoeuvre of any Minister for Finance.

Our heavy reliance on indirect taxation for revenue purposes, for example, can cause problems for the industries affected because of its impact on the volume of sales. From the Exchequer's viewpoint, if higher taxes lead to diminishing returns, then they simply defeat the purpose for which they are introduced.

Heavier direct taxes in the future

This reliance on indirect taxation is, however, the result of past policies which have deliberately exempted or relieved whole sectors of the economy – and many individuals – from the rates of taxation normal in other countries, in the interests of economic development. The limits of this policy are now being approached and it must be accepted that in future the tax net will have to be widened significantly and a higher proportion of tax revenue will have to come from direct taxation. It follows that we must also reassess critically the generous reliefs and allowances which are available at present.

The Government are looking forward to the views of the Commission on Taxation on these matters; I understand that a report will be available shortly.

The corollary of widening the tax base is the obligation to develop a more equitable tax system. There is considerable public dissatisfaction with present arrangement and there is general agreement that we need to achieve a fairer distribution of the burden of taxation. A commitment to equity also demands further progress in combating tax avoidance and tax evasion. There is still a considerable loss of revenue because of these practices and the result is that the honest taxpayer has to contribute substantially more than his fair share.

No switch to tax credits

The Government have decided against changing the present structure of income tax in order to apply tax credits. A switch to tax credits for the next income year at this stage would merely give rise to enormous administrative confusion, with little result to show for it.

It is intended, therefore, to continue with the present structure of tax bands and allowances, but changes are being made in order to achieve broadly the same effect for individual taxpayers as under the earlier proposals. As the House is aware the Social Welfare Bill provides for the implementation in full of the improved social welfare children's allowances. The £9.60 weekly payment for spouses who work in the home will not, however, be implemented. The response to this scheme has illustrated clearly that the general public saw no merit in cumbersome and complex scheme which merely transferred money from one spouse, via the Revenue Commissioners, to the other.

That scheme included a family income supplement estimated to cost £4 million this year. This supplement cannot be operated outside a tax credit system and, as I have already mentioned, I am allocating the money instead to social welfare. This, the whole amount set aside in January for income tax improvements is being provided again in this Budget and is being applied to achieve substantially the same re-distributive effects for lower and middle income groups.

While continuing the present income tax structure, I propose to increase the personal allowance from £1,115 to £1,450 for single persons and from £2,230 to £2,900 in the case of married couples. This represents an increase of 30%. The bands of income taxable at 35% will be reduced to £3,000 in the case of single and widowed persons and to £6,000 in the case of married couples.

With these changes, it is possible to achieve substantially the same effect as the tax credit proposals of January 27th, but without any of the complexity which they would have entailed.

The allowance for widowed persons will be increased to £1,950. An additional allowance for one-parent families was introduced in 1979 and now stands at £650. While this allowance has provided valuable relief to these families, I believe that further assistance is necessary. I am, therefore, providing an increase of £300 in the case of a widowed person and an increase of £800 for other single parents. As a result of these changes, widowed parents and single parents will now be in receipt of allowances equivalent to the married allowance. Widows will continue to qualify for the married allowance in the year of bereavement.

I am also improving the exemption limits for those on low incomes. The limit for single and widowed persons will be increased from £2,000 to £2,200 and from [£4,000 to] £4,400 for married couples. Marginal relief will continue for those whose income does not greatly exceed these amounts. These changes will remove about 24,000 low-income taxpayers from liability.

The elderly are a specially-deserving section of the community and I propose to provide income tax relief for them in several ways. In addition to the increase in the age allowance and the tax allowance for rent on private tenancies proposed on January 27th, I am also improving the age exemption limits by £200 for single and widowed persons and by £400 for married couples.

The changes in allowances, exemption limits and rate bands will cost £39 million in 1982 and £61 million in a full year.

As a consequence of the change in the income tax reliefs for personal loan interest announced on January 27th, some amendments may also be necessary in the provisions relating to tax relief for preferential loan interest. I am looking at this matter in the context of the Finance Bill.

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Social welfare not subject to tax

The Government will not go ahead with the earlier proposal to tax short-term social welfare benefits. Such a tax would impose an unfair burden on many who are unfortunate enough to fall ill [and] are to be made redundant and in any event it would be extremely difficult to administer the tax properly. I have no doubt that there are many cases where the existing provisions encourage absenteeism and reduce the incentive to work, but this does not warrant the general imposition of a tax on those who are in reduced circumstances and have no choice in the matter. The question of reforming the current arrangements will, however, be pursued in other ways.

Blow to private car usage

A number of changes were proposed on January 27th designed to bring about a more rational approach to the taxation and use of motor-cars. One of these concerned the arrangement under which a director or employee has the private use of a company car. At present, this benefit is completely undervalued for income tax so that what is, in effect, substantial additional remuneration escapes taxation.

The exploitation of this tax advantage has become widespread among employees who have little, if any, business travel to do and it is an observable fact that the cars so supplied are bigger and more expensive than the average. Every car, every spare part and every drop of fuel has to be imported and I see no justification for providing unnecessary encouragement to this form of motoring at a time when our balance of payments deficit is giving much cause for concern.

It was proposed in the January Budget, as an interim measure, to increase the annual valuation of the use of a motor-car from 12.5% to 20% of the cost of the car to the employer. I have taken a fresh look at the problem and I am satisfied that a new approach, based on the value of the benefit of the car to the employee, should be taken. In future, the taxable benefit will be based on a sliding scale related directly to the original market value of the car and varying according to whether the costs involved are borne partially or totally by the employer.

I appreciate that it might be unduly disruptive to make this change in a single step. I propose, therefore, to move in two stages to this new basis. For 1982-83, the taxable benefit will be calculated at half the full rates proposed, while the full rates will come into operation in 1983-84. Since most of these cars are replaced at two or three-year intervals this gives ample time to those concerned to decide their own priorities in the matter.

The details of the scales of charge are set out in the "Principal Features". These are designed to ensure that those with a substantial business mileage will be fairly treated. In particular, those with a very high business mileage, such as commercial travellers, will be given further relief, which will in effect exempt them from this charge. The yield from this change is expected to be about £2 million in 1982.

Road tax

I am proposing that the changes in road tax announced in the January Budget will be implemented with effect from May 1st, 1982. The details are set out in the "Principal Features". The extra yield is estimated at £10.5 millions in 1982 and £15.9 millions in a full year.

Insurance levy

It is proposed also to impose a levy on certain insurance transactions with effect from August 1st. The levy will be at a rate equivalent to 1% and will be imposed on premium income from domestic business excluding medical insurance. It is intended that the levy will be collected as a stamp duty on the basis of quarterly returns from the insurance companies. The yield in 1982 will be £2.25 million and the full year yield will be about £9 million.

Bank levy

The levy on the banking sector for 1982 will be £20 million. The details will be published later.

I see these levies as a temporary arrangement and I will be considering in due course proposals for the introduction of a new permanent system of taxation of financial institutions when the recommendations of the Commission on Taxation become available.

Corporation tax: payment dates

The due dates for payment of both first and second instalments of corporation tax will be brought forward by three months. In addition, the grace period before interest is charged on tax overdue will be reduced from two months to one. The combined effect will be that the first instalment will be payable not later than seven months after the end of the accounting period and the second instalment 7 to 16, rather than the present 11 to 20 months after the end of the accounting period.

These changes will bring an additional revenue of £36 million into 1982.

Capital taxes

I have looked at the proposals for capital taxation made on January 27th and I have decided to make some changes.

First, the commencement date for all the capital gains tax proposals will be March 26th instead of January 28th.

Second, the tax treatment of all short-term capital gains will be altered. These gains are akin to income and should be taxed at higher rates than gains made in the longer term. I am proposing, therefore, that gains realised within one year of acquisition will be charged at 60% and gains realised within two or three years of acquisition at 50%.

Third, I am increasing the rate of taxation on gains from disposals of development land. In January, it was proposed that such gains, including gains made by companies, would be liable to a special capital gains tax at a rate of 45%, with certain restrictions on the application of indexation relief, roll-over relief and the right to set off losses. I intend to implement these proposals but I will provide that the normal rate will now be 50% instead of 45%. Gains within one year of acquisition will be liable at the new 60% rate for such short-term gains. There will be no change in the proposed 40% rate for compulsory acquisition cases save where the new proposals for taxing short-term gains apply.

The January 27th Budget also proposed a special capital acquisitions tax on discretionary trusts. I have considered this approach and have concluded that this would be an insensitive and over-simplified approach to the problem. I am, therefore, asking the Commission on Taxation to make a special examination of this area and to recommend measures.

The delay in implementation of the new capital gains tax proposals together with the deferral of the proposed tax on discretionary trusts will reduce the additional yield from capital taxation for this year from £6.5 million to £2.7 million. This new package, however, will bring in over £11 million extra next year.

Excise duties

A number of excise duty changes were introduced from March 13th, 1982, by Government Order under the Imposition of Duties Act, 1957, as amended. This mechanism was used to minimise the revenue lost by the delay in implementing the Budget and its use was entirely consistent with legislation passed without opposition by the Oireachtas. The main duties involved are alcoholic drinks, tobacco and cars over 16 horsepower. The yield from these changes is estimated at £51.4 million in 1982 and £71.3 million in a full year. The House will today have the opportunity to debate a motion noting these changes.

I also propose to implement the other exise duty changes which were put before the House on January 27th, including a duty-based tax increase of 8p per gallon on petrol, road diesel and liquid petroleum gas used in road vehicles, which will have immediate effect. These changes will yield £21.1 million in 1982 and £24.7 million in a full year.

The excise duty increase on petrol, road diesel and LPG will take effect from midnight tonight, but increases in the price of petrol must await a new maximum prices order. This will be made by the Minister for Trade, Commerce and Tourism, who will determine the implementation date. However, if oil prices decline further during this year, it is my intention to look again at the whole question of the appropriate level of taxation on petrol and other hydrocarbon products.

VAT

There will be no VAT imposed on clothing and footwear.

The other VAT changes in the 27th January proposals will be implemented, though the date of implementation of the new 18% and 30% VAT rates will now be May 1st, 1982, and the extension of VAT to certain services which are at present exempt will now take place on September 1st, 1982. Certain professional services provided to farmers and fees on the sale of agricultural land will, however, attract the special low effective VAT rate of 3%. These changes will yield additional revenue of £71.3 million in 1982 and £147.7 million in a full year.

These are, however, two additional changes which I propose. I have been concerned for some time about the application of VAT to books, especially school books. The proposed new rate of 18% would be particularly severe in this area, so I propose to move all books to the zero rate of VAT from May 1st, 1982. This will cost £2.5 million in 1982 and £4.9 million in a full year.

Imports

As was stated in our policy document, VAT is to be imposed on imports at the point of entry. VAT-registered firms may at present, in general, import goods without payment of VAT and account for it subsequently in their normal VAT returns. I propose to change this system to require VAT to be paid at the end of the normal customs duty deferment period, that is on the 15th day of the month following importation. This change will remove the advantage which imports are seen to have over purchases of domestically-produced goods. The change will take effect from September 1, 1982. Details of how it will operate will be included in the Finance Bill.

This change will result in a gain of about £140 million for the Exchequer in 1982, since it will involve earlier payment of VAT. This includes some extra revenue from reducing evasion of VAT on imports and reducing tax losses arising from taxes unpaid in insolvencies. There will also be some gain from a reduction in arrears of VAT. If the change in relation to VAT on imports gives rise to financing difficulties for some firms, then I will look at the possibility of arranging that the Industrial Credit Company could make loan finance available.

Given the desirability of reducing the current budget deficit, the Government had little option but to apply this VAT charge to all imports. Taxation on the "old reliables" has been pushed to the limit and the two main VAT rates are already being increased substantially. The only alternative source of substantial immediate revenue would be income tax increases, which would have borne heavily on the PAYE worker and would be unacceptable to this Government at this time.

No foreign travel tax

The proposal by the previous Government to impose a £20 charge on each person leaving the State on a chartered aircraft will not be implemented. This would have discriminated against one form of foreign travel and, in particular, would have had a significant effect on certain disadvantaged groups.

It is proposed instead to spread the tax over all travellers, by applying a charge, at the rate of £3 per passenger for air and international sea routes, and £2 for cross-Channel sea routes, on all air and sea passengers who purchase their ticket in Ireland. Accordingly the tax will not apply to most foreign tourists and business persons visiting the State. The tax will apply from September 1, 1982 and is estimated to yield some £1 million in 1982.

Dating of budget changes

A number of the income and capital taxation measures announced on January 27th were to take immediate effect. Where these measures are incorporated in today's Budget, there will now take effect from a current date. It would be inappropriate to backdate their introduction as this would, in effect, correspond to retrospective taxation. The delay in bringing these measures into effect will result in a revenue loss of approximately £2.5 million.

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Deficit and borrowing

The current budget deficit planned in the January 27th Budget was £715 million. I have today added £110 million to the expenditure side of the Budget. On the revenue side of the Budget, the net increase is £146 million, which, taking account of the net increase in expenditure of £110 million, results in a current budget deficit of £679 million or 5.6% of GNP. This compares with an outturn for 1981 of £802 million, or 7.9% of GNP.

The overall Exchequer borrowing requirement emerges at £1,683 million as compared with £1,661 million planned in January. This marginal increase in the borrowing requirement is more than justified by the impact on the economy of the additional expenditure involved. At £1,683 million, or 13.9% of GNP, this requirement compares more than favourably with the 1981 outturn of £1,722 million or 16.9% of GNP.

The planned current Budget deficit and borrowing requirement represent a significant real improvement on the 1981 outturn and are an earnest of this Government's commitment to bring the public finances under control on a phased basis, having regard to the needs of the economy. The improvements in the economy which the Budget will allow should generate a sound basis for further progress in this area in the years ahead. The maintenance of progress will, however, require a sustained, businesslike approach across the broad sweep of public policies and the Government intend to apply this.

I should like to emphasise that the Government will have to take an extremely restrictive line on all requests for additional expenditure or for further taxation reliefs. The scope for any relaxation of financial discipline simply does not exist.

Conclusion

As compared with the proposals of January 27, today's Budget will have a decidedly favourable impact on employment. The removal of VAT from clothing and footwear, the imposition of VAT at the point of import and the maintenance of food subsidies will sustain purchasing power and protect the position of home industries. The increased capital allocations, particularly those for the building industry and local authorities, will give a positive stimulus to employment which will also be helped by the Employment Incentive scheme. Employment will be a central element in the medium – term plan which is being prepared.

The increases in prices as a result of today's Budget will be considerably less than those planned in the January Budget. The CPI effect is estimated at 2.75% compared with the 4.75% increase in prices which would have resulted from the January proposals. This will help to lessen inflation and encourage moderation in pay expectations. The balance of payments will also be improved through better export performance and all – round competitiveness. I estimate that, taking into account the budget changes, GDP growth this year will be higher than last year.

This Budget represents a fair balance between controlling the public finances and giving a stimulus to economic activity and employment. The extra taxation is distributed as equitably as possible, with the greater burden being imposed on those who are best able to pay. The generous social welfare changes provide considerable improvements for those who need help most. The Budget is, therefore, a sensible response to the present difficult situation. It will create more confidence in this country, both at home and abroad, and it will provide a strong imputus for greater and more stable economic progress.

The immediate task facing the Government is to nurse the economy through the present difficult economic period. While we cannot expect dramatic improvements in the short term, we have every reason to feel confident about the future. Our economy is fundamentally sound and it has the capacity to grow steadily. We have assets such as a young, growing and educated labour force which are the envy of many other countries. We must, however, go forward prudently and we must acknowledge that the correction of our public finances has to be a high priority in the immediate future whether we like it or not. This will require acceptance of the fact that we cannot sustain continuing increases in living standards, irrespective of our national output or productivity. It is on this basis, and not either on false hopes or on exaggerated pessimism, that we can advance with justified confidence in our own abilities to secure a better future for all.

Budget Highlights

Indirect taxes

- The 15% basic rate of VAT will be increased to 18% starting from 1 May 1982
- The 25% rate of VAT on "luxuries" will be increased to 30% starting from 1 May 1982
- Certain professional services (solicitors, barristers, accountants, actuaries) will become subject to 18% VAT starting from 1 September 1982
- The 25% rate of VAT on certain furniture and furnishings will be reduced to 18% starting from 1 May 1982
- VAT on books will be abolished
- Imports will become liable to VAT starting from 1 September 1982
- Excise duty on petrol (gasoline) will be increased by 8p per gallon
- Foreign air travel tax will be £ 3 per passenger (£ 2 for cross Channel transportation)
- Road tax on cars, motorcycles and taxis will be increased
- Excise duty on beer, spirits, wine and cigarettes has been increased starting from 12 March 1982

Income tax

- Personal allowances (deductions) will be increased to £ 1,450 for single persons, £ 2,900 for married taxpayers and £ 1,950 for widowed persons
- The child deduction will be *reduced* from £ 195 to £ 100
- The band taxed at the standard rate of 35% will be reduced
- The relief for mortgage interest will be restricted to a maximum of 35% and will only be granted with respect to the borrower's main residence
- The relief for interest on personal loans will be abolished
- The deduction of business expenses for entertainment will be abolished
- The rate of Corporation Tax will be increased from 45% to 50%
- The effective tax payment days will be advanced by four months
- A levy on banks will be introduced as well as a levy of 1% on insurance premiums

Capital gains tax

- Tapering relief will be abolished
- The 30% standard rate will be increased to 40%
- Short term gains in the year of acquisition will subject to a 60% rate instead of 50%
- A special land development tax will be introduced at a normal rate of 50%; in some case the tax may be increased to 60% or reduced to 40%

The Taxation of Petroleum Products

Opinion of the Commission of the European Communities

On 11 September 1981 the Commission of the European Communities submitted the following communication to the Council (COM (81) final)

Contents

1. INTRODUCTION

1.1 At the same time that the impact of the second major increase in oil prices has made structural adjustments in the economy necessary everywhere to meet the changed circumstances regarding energy, the role of prices and taxation as an instrument both of energy policy and of economic policy has been increasingly recognized. In a Council resolution of 9 June 1980 the Ministers said that energy pricing should be based on the following principles:

- "consumer prices should reflect representative conditions on the world market, taking account of long-term trends;
- one of the factors determining consumer prices should be the cost of replacing and developing energy sources;
- energy prices on the market should be characterized by the greatest possible degree of transparency."[1]

1.2 In October 1980 in its communication on energy and economic policy,[2] the Commission:

- stressed the need to keep the trend of petroleum product prices as constantly consistent as possible with the general direction of energy policy;
- hoped that the Member States, insofar as they had an influence on the formation of prices, would try to avoid developments at the level of the final consumer which would discourage energy saving and diversification, that is, energy investment.

It is proposed as an objective:

- attaining a hierarchy of prices which would serve the aims of reducing dependence on external sources of oil and would act both as a deterrent (oil) and as an incentive (other sources of energy), reflecting both these two aspects of energy policy;
- preventing excessive differences in price structures as between Member States - which can be traced back, to a large extent, to the way in which different energy products are taxed - which, given their similarity of situation and the fact that all belong to the same market, cannot be justified.

1.3 It seemed desirable to take taxation, the subject of this paper, as a starting point for analysing the main factors which determine the levels, trends and reasons for differences in the prices of energy resources, the questions of pre-tax price formation for the different forms of energy, transparency and pricing itself being treated in a separate paper to follow.

2. ENERGY AND ECONOMIC POLICY

2.1 The medium-term Community strategy proposed in the Fifth Economic Policy Programme makes the reduction of reliance on external sources, that is to say of consumption of imported energy and especially oil, a major goal, whose attainment is dependent on two variables which ar economic in nature: energy investments and energy prices. This is the reason why the Commission has asked that increases should be passed on immediately and in full to the final consumer and on the other hand that any ensuing secondary inflationist effects should be as far as possible reduced to a minimum. In connection with this, in its communication on the principles of indexation in the Community,[3] the Commission tries to reconcile the economic concern of the moment - reducing the rate of inflation - and the longer-term objective - increasing energy indepence - and recommends exclusion from indexation of: "the impact of any changes in indirect taxes and certain public service prices" and "the rise in prices attributable to a deterioration in the terms of trade due, for example, to a rise in important raw material prices".

2.2 Having regard to the direction to be followed in energy matters, a price policy should be developed which made it possible both to:

- ensure *"true prices"*, which would mean that consumer prices fully reflected the costs of production, transport and distribution, and the investment costs of developing future sources, and to
- give the consumer as clear and stable a picture as possible of *price trends* so that both industry and households would be able to make rational investment decisions which would contribute to restructuring energy supply and demand.

In pursuing these objectives, however, account must also be taken of others, such as those laid down for energy saving, combatting inflation, tax revenue, social policy and the constraints experienced by energy producers (balancing, the budget, commercial policy, etc.).

2.3 Although a single general principle could be used to analyse price formation for the various forms of energy, it is obvious that since for each of them production follows its own individual course each form must be analysed separately (see the paper: Energy Prices: Policy and Transparency, to be transmitted to the Council). In the case of crude oil and refined products their prices are extremely unstable, and the fact that oil products dominate a large part of the energy market means that this instability is passed on to the other forms of energy.

2.4 Nonetheless, in the long term the price of oil will be mainly determined by the price of alternative forms of energy. For some uses, particularly as fuel and in the petro-chemical industry, there are hardly any substitutes for hydrocarbons, and alternatives to conventional oil could only come from oil shale, tar sands or coals. But for other pur-

1. Official Journal of the European Communities (hereinafter "OJ") No. C 149/4, 18 June 1980.
2. COM(80) 583, 15 October 1980.
3. COM(81) 457, 23 July 1981.

poses, in particular heat and electricity production, more economical alternatives already exist and the use of oil should be discouraged here.

2.5 Out of the range of energy products, those whose consumption absolutely must be reduced, petroleum products, are also those whose prices are most subject to control by the Member States in the form of taxation. Oil taxes are generally heaviest on those products for which there are few substitutes (see findings below). If in the medium term the price mechanism should have a role to play, taxation too should be used in such a way as to reinforce its effects. Also, many countries are faced with the need to limit or reduce their public deficits, which leads them to accord particular importance in their economic policies to analysing and controlling the sources of tax revenue.

2.6 The manner in which petroleum products are taxed must contribute to diminishing generally these clashes between objectives, provided the line followed here is consistent with macro-economic and energy policy. Action to achieve this is already both feasible and desirable at Community level.

3. OIL TAXES: FINDINGS AND EFFECTS

3.1 Unlike other forms of energy (coal, gas and electricity) on which there are vitually no taxes other than VAT (which is charged only on final consumption), on petroleum products there are specific charges (excise duty on mineral oils) which can be quite heavy. A detailed analysis of oil taxes, both the origin of and justification for the general arrangements and the exceptions, is given in the Annex, the main conclusions being the following:

- because of their yield in tax revenue, excise duties are heaviest on motor fuel (petrol and diesel) and quite light on furnace fuel;
- the adaptation of the rates of excise duties to general price trends has tended to be very irregular and belated in most countries;
- there are very substantial differences in the rates of excise duty applied in the different countries, particularly in the case of diesel fuel;
- the structure of excise duties varies from one member State to another;
- in all Member States there are different arrangements for exemptions or subsidies the economic justification for which in many cases is not obvious. The Commission proposes that the Council adopts as a principle their progressive elimination on the basis of a joint study with national administrations. Particular attention should be paid to air and inland waterways transport, agriculture and oil consumption within certain industrial sectors (e.g. refineries, petro-chemicals).
- with regard to VAT, the normal rates are usually applied (with the customary differences between countries), but some countries apply reduced or zero rates for certain products.

3.2 From these summary findings certain conclusions should be drawn as regards economic and energy objectives:[4]

- the products that are most heavily taxed are not those that offer the greatest opportunities for saving or the use of substitute products;
- the irregular timing of adjustments in excise duties has not generally contributed to smoothing price changes for oil products, which have been masked by sudden sharp movements in pre-tax prices;
- the delays in adapting excise duties to general price trends over the period 1973-81 has in many cases produced a substantial loss in potential tax revenue;
- the absence at European level of any concerted oil tax policy, both for the direction to be followed and the structure of taxation, has made users less aware of the absolute necessity of reducing oil consumption;
- lastly, certain differences in rates of taxation have provoked distortion of competition and have impeded the proper allocation of resources.

3.3 In practice it may prove difficult to make the changes needed to adapt oil taxation; at all events it will be necessary to spread the changes out over a certain period if economic activity is not to be disrupted, as the present systems of taxation affect both sectoral and regional economic structures. In addition the effect of such changes on the competitivity of firms could be important, at least in the short term, in sectors where oil prices form a major part of production costs. Time will also be needed on the supply side for refining structures to be altered. Furthermore, the complexity of tax structures, the interaction between the rates and the products covered by excise duties, the existence of other forms of taxation (on demand for but also on supply of petroleum products) and the multiplicity of objectives do not lend themselves readily to any single solution.

3.4 If the arrangements decided on led to an increase in public revenue, naturally, inflationist effects would have to be kept under control and deflationist effects averted. To this end, appropriate compensations should be sought in line with the budget situations of the individual Member States, so as to reduce the charges borne by Community undertakings, to increase the budget funds devoted to energy adjustment and to assist low-income categories of society directly affected by the rise in prices for certain petroleum products or the abolition of certain exemptions or reductions in the rate of taxation.

4. OIL TAXES: A JOINT EFFORT

4.1 The considerations set out above enable priorities to be defined for selecting the options that will give a system of oil taxation more in keeping with Community objectives. Ideally, oil taxes should:

- contribute to a more regular adjustment of oil prices, while maintaining a constant and substantial flow of tax revenue;
- encourage the adaptation of the structure of energy prices as a whole and the introduction of a price hierarchy for petroleum products which reflects energy objectives and thus prompts the realization of the major potential for saving and the use of substitute products that exists in the Community;
- reduce the differences in the tax structures and charges within the Community, particularly by keeping special arrangements (exemptions, subsidies) to a strict minium.

4.2 Obviously it would be desirable if oil taxation as a whole, or failing this, the structure of excise duties on mineral oils,[5] could be harmonized, and this would contribute to solving most of the problems, but would take a long time. Without waiting for this work to be terminated, and concurrently with it, objectives should be set that are in line with the general approach and will enable rapid progress to be made. These would include the following five practical goals:

- agreement that sizes for the tax burden to be applied in target areas should be set for each major category of product (i.e. the minimum and maximum incidence in relation to the prices net of tax for all excise duties and VAT), so as to have a direct impact on their price structures and bring them more in line with energy objectives;
- a joint decision of the rate of progression of the overall tax burden (excise duties + VAT) towards the target areas and on the proper balance between excise duties and VAT. Watch must be kept to ensure that changes in the tax burden remain at all times in line with target areas;
- a joint agreement on the need to adapt excise duties regularly, without however revising the level more than once a year;
- adoption of the principle of the gradual abolition, following a timetable jointly agreed, of exemptions, subsidies and reductions of the rate of taxation for particular uses where there is no longer any valid reason for keeping them;
- a decision that the Council should review the trends in energy and particularly oil taxes (both structures and rates) annually, to assess to what extent they contribute to achieving the objectives of economic and energy policy.

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4. A detailed analysis of the effects of oil taxes on competitiveness, tax revenue and demand for petroleum products (particularly from the point of view of possible substitution effects) is annexed.

5. The Commission has already presented a proposal for a directive on the harmonization of excise duties on mineral oils (OJ No. C 92, 31 October 1973) which could provide a basis for any fresh discussion of the subject.

ANNEX

A. TAXATION OF OIL PRODUCTS - SITUATION*

A.1 The tax burden on oil products is made up of specific charges (excise duties) and value added tax, which is levied on the sum of the excise duties and the price exclusive of tax. Table 1 gives the different levels of excise duty expressed in EUA and their incidence as a percentage of the price exclusive of tax, the rates of VAT and the total tax burden (excise duties + VAT as a percentage of the price exclusive of tax) as at 1 January 1973 and 15 July 1981.

A.2 However, discussion of the main features, with their effects, of the taxation of oil products must take account of two factors that impinge on the inferences to be drawn from the information set out below:
- in most countries, there are other ancillary tax measures that, to differing degrees, have a direct impact on the size of the overall tax burden on the use of certain oil products (e.g. axle tax in France, road taxes, taxes on the purchase of motor vehicles);
- the share of oil in energy consumption differs very significantly between some countries, particularly in energy-intensive sectors, whether as a result of policy decisions or as a result of the straightforward operation of the law of comparative advantages (see Table 2).

A.3 Excise duties

A.3.1 Since the taxation of mineral oils used as motor fuels was a potentially valuable source of tax revenue, Member States initially imposed high excise duties on them for the purpose of ensuring a steady and substantial flow of tax revenue. The subsequent increases in the duties on motor fuels were justified on several counts, e.g. the need to finance the infrastructure costs of private and commercial road transport, enviromental problems and, of course, energy conservation. As a result, excise duties were also levied on a variety of other oil products the use of which does not generally give rise to transport infrastructure costs.

In many cases, the aim of taxing these other uses of oil products was to protect indigenous energy resources, especially coal. Consequently, oil products are now taxed for purposes that differ not only from country to country but also from one oil product to another and even from one use to another of the same product. Taking the Community as a whole, the Member States' tax systems exhibit marked differences in both the rates and the application of excise duties for the entire range of oil products; and different arrangements governing exemptions and reductions for particular uses have come into being.

A.3.2 The level and trend of excise duties in the Nine as at 1 January of each year from 1973 to 1981 are given in Graphs A1 to A4. It will be seen that:
- as a rule, motor fuels (petrol and diesel oil) are much more heavily taxed than heating fuels (heating oil and heavy fuel oil);
- although all the nine countries have adjusted the levels of their excise duties during the period 1973-81, these still differ appreciably from one country to another; most important, owing to the impact of inflation, they have very seldom held their real value throughout the period: this applies particularly to motor fuels. Even though in many cases recent adjustments have restored the real value of excise duties at 15 July 1981 to levels near or higher than their value at 1 January 1973, they have nonetheless been substantially eroded over the period; this emerges clearly from Tables 4 and 6 and Graphs B1 to B4;
- in the case of motor fuels, excise duties on diesel oil show the greatest disparity between countries. They are identical to the excise duties on heating oil in Denmark and Italy (in the latter they are very low at only 4% of the duty on petrol), while in the United Kingdom they are the same as the duty on petrol (i.e. they are around 20 times higher than in Italy);
- generally speaking, excise duties on heating oil are low but there are quite appreciable differences between countries: expressed as a percentage of the price exclusive of tax, they range from 0 in Belgium to 16.1% in Denmark (where, however, the duty is refunded to persons subject to VAT if VAT on the purchase of oil products is deductible);
- in the case of heavy fuel oils, which for the most part are used in industry, the tax treatment of excise duties differs a great deal and this has an obvious bearing on competition. They are exempt in France and Belgium, but subject to excise duties amounting to 11.5% of the price exclusive of tax in Ireland, 7.1% in the United Kingdom (although there are exemptions for the oil industry) and as much as 24.5% in Denmark (where, however, the duty is refunded in the same way as that on heating oil);
- in the case of lubricants, the rates range from zero in a number of Member States to 211 EUA per tonne in Germany.

A.4 Value added tax

A.4.1 As regards value added tax, it has to be borne in mind that the practical effect of the system of deducting VAT in all Member States (except France, where VAT levied on oils other than heavy fuel oil is not deductible) is to exempt oil products used in industry, with the result that the entire burden of the tax is shifted to private consumption.

A.4.2 Since 1973, VAT rates have been raised in all Member States except Belgium (where the standard rate was cut from 18% to 16% in 1979, while most of the products chargeable at the reduced rate of 14% are now taxed at the standard rate of 16% and certain products are taxed at the increased rate of 25%) and France (where the rates have remained unchanged). Although these adjustments have applied across the board in that more often than not they have taken the form of a change in the standard rate, they have contributed to increases in the prices of oil products at final consumption and, primarily because VAT is an ad valorem tax, they have boosted tax revenue, thereby making up to some extent for the fact that excise duties had lagged behind the trend in the general price level.

A.4.3 Generally speaking, oil products are chargeable at the standard VAT rate, which ranges from 10% in Luxembourg to 22% in Denmark; but some member States apply different rates for different products:
(i) motor fuels are taxed at the reduced rate in Ireland (15%, with effect from 1 September 1981) and Luxembourg (5%), and at the increased rate in Belgium (25%);
(ii) heating fuels (heating oil and heavy fuel oil) are zero rated in Ireland and the United Kingdom, and taxed at the reduced rate of 5% in Luxembourg;
(iii) the reduced rate of 4% that was applied to diesel oil and heating fuels in the Netherlands was replaced in 1979 by the standard rate of 18%.

A.5 The structure of the taxation of oil products in the Community can thus be broadly summarized as follows:
VAT: falls on the final private consumer. Rates on motor fuels for road transport range from 5% to 25%; rates on other oil products range from 0% to 22%.
Excise duties: 90% or more of the excise duties levied affect motor fuels for road transport, which account for about 30% of all oil products consumed (see Table 3).

The range of rates of tax on petrol is fairly narrow, but there are wide differences between the rates applied to petrol and those applied to diesel oil, and the latter vary considerably from one country to another. Other oil products are for the most part taxed at fairly low rates or completely exempt. Differences in rates of tax on heavy fuel oil may be a direct cause of distortion of competition between industries.

A.6 In many cases, the aggregate revenue from the taxation of oil products was declining in real terms over fairly long periods between 1 January 1973 and 15 July 1981. It is clear that, in view of the enormous rise in prices net of tax (a five-fold increase over the period), the total tax burden (excise duties plus VAT as a percentage of prices net of tax) has declined considerably in all countries and, with a few rare execptions, for all products (see Table 2).

A.7 Exemptions and subsidies

A.7.1 As well as this wide variety of arrangements, which makes it difficult to assess the system as a whole, there are a number of exemptions, rebate schemes or reduced rates for specific uses. These special

* Graphs to which the Annex refers have not been reproduced.

provisions are the subject of a Commission staff working paper entitled "Subsidies and tax exemption for energy consumption"[6] and are listed in tabular form in the document "Excise and VAT exemptions and reductions in favour of certain groups of mineral oil consumers"[7]; this conspectus is reproduced here as Table 7. It shows the special arrangements in force in the Member States for nine types of use:

(i) aviation: in most countries, consumption by commercial traffic is exempt from excise duties and usually from VAT as well (although VAT, when applied, is deductible except in France); consumption by executive aircraft is exempt from excise duties, and in general only consumption by private aircraft is taxed, although sometimes at reduced rates;
(ii) navigation in territorial waters: consumption is largely exempt in all countries for inshore navigation, fisheries and transport, while consumption by pleasure boats is normally subject to the standard rate;
(iii) agriculture and horticulture: consumption is usually exempt from excise duties or taxed at a reduced rate (the reduced rates in force for heating oil are often applied to motor fuels);
(iv) own use of oil products by refineries and the petrochemical sector is exempt everywhere;
(v) public transport: oil products used by the railways are either exempt (Germany and Italy), eligible for tax rebates (Denmark) or taxed at a reduced rate (Belgium, France, the UK, Ireland, Luxembourg and the Netherlands); only Germany refunds excise duties on consumption by public bus services, and it is to discontinue these arrangements by 1983; in the other countries, the standard rate on diesel oil is applied, except in Ireland and Italy;
(vi) consumption by diplomatic missions, international organisations and the armed forces of a foreign state is totally exempt everywhere;
(vii) reclaimed oils are subject to the standard rate of excise duty on lubricants only in Germany and Luxembourg, while Italy applies a reduced rate and other countries grant exemption.

A.7.2 Most countries, then, grant substantial tax reductions for most of these types of consumption. The justification for the reductions is not always obvious, for their origins are diverse: historical reasons such as international agreements, social reasons, technical reasons such as own use, tax reasons or even energy policy reasons. The Commission, in collaboration with national government departments, should carry out a detailed study of the implications and effects of abolishing certain exemptions, rebates or reduced rates, and the arguments for doing so, so that practical proposals may be presented along with a timetable for applying them.

Although each of the special schemes must be investigated in the light of all the reasons for its existence, certain situations should be given special attention. For example, energy considerations may well justify special treatment for consumption for the purposes of inland waterway transport or public transport (particularly by rail), or for own use, which often means the use of by-products with little productive potential that might be replaced by something less suitable if taxed.

B. THE TAXATION OF OIL PRODUCTS: EFFECTS

B.1 From the situation described above, a number of conclusions can be drawn about the effects of the taxation of oil products, or rather the effects of specific taxes in the form of excise duties, the main source of difficulties. We are concerned with the repercussions in three areas: competitiveness, tax revenue and the demand for oil products.

B.2 Competitiveness

Except in a few specific sectors, energy costs usually account only for a small part of aggregate production costs. However, it is clear that the impact of the price trend of oil products on production costs varies widely as a result not only of different structures of energy consumption, but also of differences in tax treatment, and this distorts relative price competitiveness. For example, the share of oil products in the total volume of energy consumed by manufacturing industry in 1979 varied from 22% in the Netherlands and Belgium to about 70% in Ireland and Denmark; the share in Germany was slightly over 30%, and the share in France, Italy and the United Kingdom about 40%. A comparable range of figures is observed in the residential/tertiary sector, although the ranking by countries is different. The Member States' different systems for taxing oil products, described above, frequently do not offset the effects of consumption structures, thereby amplifying differences in the competititve positions of European firms.

If certain excise duties were increased and periodically adjusted, there should be no major repercussions on the international competitiveness of most European exports: in fact, this might act as an additional incentive for investment to rationalize industry, which would improve competitiveness in general in the medium term. However, the sectors that are still heavily dependent on oil, or in which oil products account for a very large share of production costs (steel, man-made fibres, etc.) might find it extremely difficult to remain competitive.

B.3 Tax revenue

B.3.1 In none of the Member States is the policy governing the changes in excise duty rates amenable to logical analysis, in so far as it is based neither on the general movement in prices nor on the requirements of energy policy, whether in the direct measures to discourage consumption of mineral oils or in the indirect measures for manipulating the prices of products that can be substituted for mineral oils.

Many Member States have allowed the specific rates of the excise duties on mineral oils, or at least some of them, to lag behind the general trend in prices. In so doing, they have generally lost sight of the primary objective of excise duties, which is to raise revenue for the State. An illustration is provided by Table 4, which clearly shows that revenue from the excise duties on mineral oils expressed as a precentage of GDP has fallen in many countries, whereas consumption of motor fuels - which account for the major proportion of excise duties - has increased in all countries.

B.3.2 Table 6 gives an estimate of the revenue forgone owing to the failure to adapt excise duty rates in line with the general movement in prices. Thus, if excise duties had been increased each year from 1973 to 1979[8] in step with the overall rise in prices, several countries would have collected appreciably higher revenue each year: aggregated over the period from 1973 to 1979, this "extra" revenue, calculated at current prices, would in some cases have nearly amounted to their total revenue for a single year. The figures also show up differences of approach: some countries have adapted excise duties comparatively frequently; others, some years after the first oil shock, have suddenly increased the rates in an effort to catch up; and in others again, the rates have constantly lagged behind the general movement in prices.

B.3.3 However, this finding must be qualified by the fact that, since VAT is an ad valorem tax and oil prices net of tax have been rising steeply, VAT revenue has increased substantially, thereby offsetting the effects on tax revenue of the slow increase in excise duties.

B.4 Demand for oil products

B.4.1 A distinction must be made between the very different markets for oil products. These markets reflect a clear division between private consumption, that of the tertiary sector and that of the productive sector - with its own economic impact.

B.4.2 *Motor fuels:* in this market, there is practically no substitute for oil in the short or medium term. However, consumption could certainly be made more efficient: recent studies suggest that the price elasticity of demand is generally greater than has hitherto been assumed (ranging form approximately -0.2 to -0.4 in the short term and from -0.4 to -0.9 in the long term).

Even leaving aside additional ways of taxing consumption (e.g. road tax), the present level of taxation of motor fuels is very high compared with that of other products. However, a distinction must be made between petrol and diesel oil. Excise duties on petrol are high, but had their real value been maintained from 1973 to 1980 they would in many cases have been much higher by now and the revenue to the State correspondingly larger, without making an excessive impact on the price inclusive of all taxes (see Table 5). In five countries, the price

6. SEC(81)939 of 10 June 1981.
7. SEC(81)1314 of 31 August 1981.
8. At this point the calculations cannot be taken beyond the year 1979. The 1980 figures will probably be available in the autumn.

of petrol would have been approximately 15% higher on average in 1980, which, in view of the price elasticities of demand, might well have led to appreciable savings. In all the countries, diesel oil is taxed at lower levels than petrol, often much lower. Whereas in the past diesel oil was used by and large only in the commercial and productive sectors, the proportion of moter vehicles using it is now increasing rapidly. As the present levels of excise duty on this product in many countries do not encourage energy savings, it would be desirable for taxation on motor fuels to be aligned, i.e. the lowest levels of excise duty on diesel oil should be increased. Steps should also be taken to ensure that the structure of excise duties does not encourage substitution by other forms of energy such as liquified petroleum gas which offer few or no advantage from the viewpoint of energy policy.

B.4.3 *Heating oil:* this product is used mainly in the tertiary and residential sectors for heating. The most attractive substitutes are natural gas, district heating and electricity in the form of electric heat pumps. In all countries, there is considerable potential for conserving energy and for rationalizing consumption through house insulation, inspection and maintenance measures, etc. The current level of taxation (excise duties and VAT) is generally low, although it varies greatly according to country. There are therefore grounds for increasing the level of taxation where it is at present particularly low. Here again, however, one must guard against encouraging a massive switch to the single alternative of natural gas.

B.4.4 *Heavy fuel oil:* the prospects of using substitutes for this product are good, because it is consumed by industry where electricity, coal and gas offer satisfactory alternatives. The level of excise duties is generally low, but there are substantial differences between countries. Besides the problem of competitiveness which arises from this situation, there is little encouragement to conserve energy and adopt alternative processes. For both reasons, the excise duty rates in the Community should be brought up to a common level.

B.4.5 *Non-energy consumption:* in addition to the uses described, oil is also used as a feedstock, particularly in the form of naphtha (chemically similar to petrol). No tax is currently imposed on this use. Since there is as yet no possibility of substitution and since the potential for making savings is limited, there is little reason to introduce significant levels of excise duty.

TABLE 1

	Belgium				*Denmark*				*FR Germany*				*France*			
	PGP	*D*	*HO*	*HFO*	*PGP*	*D*	*HO*	*HFO*	*PGP*	*D*	*HO*	*HFO*	*PGP*	*D*	*HO*	*HFO*
1 January 1973																
a) Excise duties in EUA[1]	153.1	61.5	10.8	2.4	103.9	0	0	0	174.5	163.4	3.3	5.9	105.9	59.1	3.1	0
b) Excise duty rates as % of price exclusive of tax	241.9	109.9	24.4	11.8	170.3	0	0	0	190.7	198.5	7.0	21.1	174.6	119.8	9.4	0
c) VAT rate	18	18	14	14	15	15	15	15	11	11	11	11	17.6	17.6	17.6	17.6
d) Total impact (excise duties + VAT as % of price exclusive of tax	303.4	147.7	41.8	22.5	210.8	15	15	15	227.7	231.3	18.8	34.4	222.9	158.5	28.7	17.6
15 July 1981																
e) Excise duties in EUA[1]	203.5	83.6	0	0	243.3	45.6	45.6	5.20	202.4	177.4	6.7	5.9	235.9	124.5	23.1	0
f) Excise duty rates as % of price exclusive of tax	54.0	26.7	0	0	69.9	14.7	16.1	24.5	60.3	59.6	2.5	3.2	70.8	41.9	8.1	0
g) Index of real value of excise duties (1973 = 100)[2]	72.3	74.0	–	–	104.6	–	–	–	77.6	72.7	135.6	67.7	95.5	90.4	324.1	–
h) VAT rate	25	25	16	16	22	22	22	22	13	13	13	13	17.6	17.6	17.6	17.6
i) Total impact (excise duties + VAT as % of price exclusive of tax)	92.5	58.4	16	16	107.3	39.9	41.7	51.8	81.1	80.4	15.8	16.4	100.8	66.9	27.1	17.6

TABLE 1 (cont.)

	Ireland				*Italy*				*Netherlands*				*United Kingdom*			
	PGP	*D*	*HO*	*HFO*	*PGP*	*D*	*HO*	*HFO*	*PGP*	*D*	*HO*	*HFO*	*PGP*	*D*	*HO*	*HFO*
1 January 1973																
a) Excise duties in EUA[1]	57.6	52.6	0	0	79.0	34.3	2.3	0.6	150.2	60.1	11.6	5.0	89.8	89.9	4.1	4.2
b) Excise duty rates as % of price exclusive of tax	163.5	157.7	0	0	237.1	152.6	14.4	5.6	196.0	91.2	24.1	25.0	178.0	195.7	10.7	22.1
c) VAT rate	5.26	5.26	5.26	5.26	12	12	12	12	16	4	4	4	0	0	0	0
d) Total impact (excise duties + VAT as % of price exclusive of tax	177.4	171.1	5.26	5.26	277.6	182.9	28.1	18.3	243.4	98.8	29.1	30.0	178.0	195.7	10.7	22.3
15 July 1981																
e) Excise duties in EUA[1]	239.3	157.5	25.9	27.0	316.6	13.0	13.0	0.8	190.1	65.8	11.6	5.0	250.0	215.5	13.8	14.5
f) Excise duty rates as % of price exclusive of tax	65.5	45.6	8.8	11.5	101.4	4.8	5.1	0.4	53.9	22.6	4.3	2.6	74.3	69.0	4.5	7.1
g) Index of real value of excise duties (1973 = 100)[2]	113.5	87.2	–	–	107.9	10.7	158.2	33.7	69.8	60.4	55.2	55.2	83.9	72.3	105.1	104.7
h) VAT rate	10	10	0	0	18	15	15	15	18	18	18	18	15	15	0	0
i) Total impact (excise duties + VAT as % of price exclusive of tax)	82.1	60.1	8.1	11.5	137.7	20.6	20.8	15.5	81.6	44.6	23.8	21.0	100.4	94.4	4.9	7.1

PGP = premium grade petrol; D = diesel oil; HO = heating oil; HFO = heavy fuel oil.
(1) Per 1,000 l for premium grade petrol, diesel oil and heating oil; per tonne for heavy fuel oil.
(2) Excise duties deflated by GDP prices and expressed as an index (1973 = 100).

* 15% as from 1 September 1981.
Source: Commission departments.

TABLE 2

Share of oil products in the final energy consumption of the three sectors

	Share of oil products in the final energy consumption of:	*B*	*DK*	*D*	*F*	*IRL*	*I*	*NL*	*UK*
1975	Industry	26.2	70.7	34.6	49.6	83.0	45.5	15.0	39.2
	Transport	98.4	99.7	96.9	97.8	100.0	96.5	98.9	98.9
	Residential/tertiary	59.5	79.1	60.4	63.4	44.6	67.2	22.7	21.2
	Total	51.7	81.9	58.1	66.1	73.3	64.8	34.4	45.3
1979	Industry	22.0	67.2	30.7	44.4	70.0	40.1	21.8	38.3
	Transport	98.6	99.7	97.6	98.0	100.0	97.4	99.0	98.8
	Residential/tertiary	55.8	76.6	59.1	58.2	38.6	60.4	16.6	21.1
	Total	49.5	79.4	57.2	62.8	65.8	62.2	33.4	45.3

TABLE 3

Part of consumption (A) and of excise revenue on hydrocarbon oils (B) for the main products groups 1973

Products		EUR %	B %	DK %	D %	F %	IRL %	I %	L %	NL %	UK %
Motor spirit	A	19.3	16.2	13.0	19.0	18.7	24.3	16.8	18.0	16.0	25.9
	B	72.2	75.2	82.8	67.2	70.8	79.5	80.8	81.4	78.8	67.8
Diesel road fuel	A	8.7	7.5	4.7	7.3	8.9	9.1	12.9	6.1	8.6	8.3
	B	15.6	11.2	0.3	21.6	15.5	10.9	4.5	6.4	14.5	22.6
Gas-oil for heating	A	32.3	42.4	43.6	44.0	36.1	24.2	22.2	35.5	14.3	18.1
	B	5.7	10.3	10.7	2.6	9.7	3.2	5.7	9.8	4.2	3.5
Heavy fuel oil	A	18.2	17.4	25.7	12.7	17.9	24.6	27.5	30.9	6.5	22.0
	B	1.6	0.8	0.4	2.9	0	2.9	0.3	2.3	0.7	3.7

TABLE 4

Tax revenue from excise duties on mineral oils, expressed as % of GDP

	B	DK	D	F	IRL	I	NL	UK
1970	1.8	1.2	1.7	1.7	2.9	2.4	1.5	2.7
1971	1.8	1.2	1.6	1.7	2.7	2.7	1.4	2.3
1972	1.7	1.1	1.7	1.6	2.4	2.5	1.5	2.4
1973	1.8	1.0	1.8	1.6	2.1	2.2	1.4	2.2
1974	1.5	0.9	1.6	1.5	2.0	2.1	1.3	1.9
1975	1.6	0.9	1.7	1.4	2.5	2.6	1.3	1.5
1976	1.5	0.9	1.6	1.3	2.8	2.2	1.2	1.6
1977	1.5	1.0	1.6	1.5	2.6	2.4	1.2	1.7
1978	1.4	1.0	1.6	1.7	2.5	2.3	1.2	1.5
1979	1.4	–	1.5	1.9	–	2.1	1.1	1.5

TABLE 5

Price of premium grade petrol in EUA per 1,000 litres

	B	DK	D	F	IRL	I	NL	UK
a) 1973	223.8	202.3	210.3	221.3	157.7	226.1	217.6	153.9
b) 1980	574.6	590.7	469.6	583.0	486.7	602.7	526.9	473.6
c) 1980 notional	660.6	560.1	541.1	549.5	510.4	540.2	586.9	606.6
$d = \frac{c \times 100}{b}$	115.0	94.8	115.2	94.3	104.9	89.6	111.4	128.1

TABLE 6

Comparison between actual excise duty revenuefrom mineral oils and the excise duty revenue which would have been collected if the rate had been adjusted in line with the general movement in prices[1]

	In million BFR *BELGIUM*			In million DM *GERMANY*			In million FF *FRANCE*		
	Actual revenue	*Notional revenue*	*Gain or loss*	*Actual revenue*	*Notional revenue*	*Gain or loss*	*Actual revenue*	*Notional revenue*	*Gain or loss*
1973	31692	31692	–	16589	16589	–	17777	17777	–
1974	29891	33704	+3813	16052	17177	+1125	18920	22481	+3561
1975	37451	46914	+9463	17121	19416	+2295	20270	25448	+5178
1976	39330	52713	+14383	18121	21418	+3297	21419	28799	+7380
1977	40445	53644	+13199	19184	23248	+4064	28070	31827	+3757
1978	42571	57446	+14875	20462	25401	+4939	35815	34764	-1051
1979	44558	61376	+17318	21114	26987	+5847	46517	40294	-6223
			+73051			+21567			+12602

TABLE 6 (cont.)

	In '000 million LIT *ITALY*			In million HFL *NETHERLANDS*			In million £ *UNITED KINGDOM*		
	Actual revenue	*Notional revenue*	*Gain or loss*	*Actual revenue*	*Notional revenue*	*Gain or loss*	*Actual revenue*	*Notional revenue*	*Gain or loss*
1973	1959	1959	–	2370	2370	–	1618	1618	–
1974	2291	2039	-253	2500	2530	+30	1556	1805	+249
1975	3230	2966	-264	2730	3034	+304	1521	2192	+671
1976	3468	2980	-487	2880	3381	+501	1941	2639	+698
1977	4537	3622	-915	3070	3841	+771	2377	3133	+756
1978	4989	4490	-499	3270	4268	+998	2465	3523	+1058
1979	5691	5923	+232	3340	4562	+1222	2777	4210	+1433
			-2186			+3826			+4365

(1) All other things being equal, i.e. assuming unchanged quantities, which makes for an over-estimate of the notional revenue. It is assumed that the purpose of adjusting excise duties is to maintain the real value of excise duties at the 1973 level.

TABLE 7 *

Excise and VAT exemptions and reductions in favour of certain groups of mineral oil consumers (Sit. 15/7/81)

A. Normal rates	BELGIUM Excise (ECU/hl)	BELGIUM VAT %	W.GERMANY Excise (ECU/hl)	W.GERMANY VAT %	DENMARK Excise (ECU/hl)	DENMARK VAT %	FRANCE Excise (ECU/hl)	FRANCE VAT %	UNITED KINGDOM Excise (ECU/hl)	UNITED KINGDOM VAT %
01 Rates generally applied for road fuels:										
a) petrol	20.35	25(17)	20.24	13	24.33	22	22.14-23.59	17.6[2]	25.00	15
b) DERV	8.36	25(17)	17.74	13	4.56[1]	22	12.45	17.6[2]	21.55	15
c) LPG	4.84	25(17)	15.71	13	3.04[1]	22	6.31	17.6[2]	12.50	15
02 Rates generally applied for heating fuels:										
a) heavy fuel oil	0	17	0.59/100kg	13	5.20/[1] 100kg	22	0	17.6	1.45/100kg	0(15)
b) heating gas-oil	0	17	0.67	13	4.56[1]	22	2.31	17.6[2]	1.39	0(15)
c) light oil	0[3]/20.35	17	0[3]/20.24	13	0	22	0[3]/22.14	17.6	1.39[3]/25.00	0(15)
d) LPG	0	17	0	13	3.08[1]	22	0	17.6	0	0(15)
03 Rates generally applied for use in motors other than those of road-vehicles:										
a) petrol	20.35	25(17)	20.24	13	0	22	22.14-23.59	17.6[2]	25.00	15
b) gas oil	0	17	17.74	13	4.56[1]	22	2.31	17.6[2]	1.39	15
04 Rates generally applied for non-energetic use:										
a) raw material, solvent etc.	0	17	0	13	0	22	0	17.6	0	15
b) lubricants	0	17	21.13/100kg	13	0	22	0	17.6[2]	1.55/100kg	15

A. Normal rates (cont.)

	GREECE Excise (ECU/hl)	GREECE VAT %	IRELAND Excise (ECU/hl)	IRELAND VAT %	ITALY Excise (ECU/hl)	ITALY VAT %	LUXEMBOURG Excise (ECU/hl)	LUXEMBOURG VAT %	NETHERLANDS Excise (ECU/hl)	NETHERLANDS VAT %
01 Rates generally applied for road fuels:										
a) petrol	16.23-18.86	?	23.93	10[4](25)	31.66	18(15)	16.86	5(10)	19.01	18
b) DERV	1.12	?	15.75	10[4](25)	1.30	15	4.84	5(10)	6.58	18
c) LPG	0	?	12.74	10[4](25)	19.04	18(15)	2.18	5(10)	0	18
02 Rates generally applied for heating fuels:										
a) heavy fuel oil	0	?	2.70/100kg	0(25)	0.08/100kg	15	0.24/100kg	5(10)	0.50/100kg	18
b) heating gas-oil	1.12	?	2.59	0(25)	1.30	15	0.60-0.92	5(10)	1.16	18
c) light oil	?	?	0[3]/23.93	0(25)	0[3]/31.66	15	0[3]/16.86	5(10)	0[3]/19.01	18
d) LPG	0	?	2.59	0(25)	0.90	15	0	5(10)	0	18
03 Rates generally applied for use in motors other than those of road-vehicles:										
a) petrol	16.32-18.86		23.93	10[4](25)	31.66	18(15)	16.86		19.01	18
b) gas oil	1.12		2.59	10[4](25)	1.30	15	0.60-0.92	5(10)	1.16	18
04 Rates generally applied for non-energetic use:										
a) raw material, solvent etc.	0		0	10[4](25)	0	15	0	5(10)	0	18
b) lubricants	12.99/100kg		2.89/100kg	10[4](25)	14.34-15.93/100kg	15	0.24/100kg		0	18

* *Editor's note:* (a) Unlike the official EEC document where international codes are used, here full country names are given.
(b) For footnotes to this table, see at the end of Table 7.

TABLE 7 (cont.)

B. Reductions or exemptions of excise and/or VAT granted to certain consumer groups

	BELGIUM		*W.GERMANY*		*DENMARK*		*FRANCE*		*UNITED KINGDOM*	
Consumer groups	*Excise (ECU/hl)*	*VAT %*	*Excise (ECU/hl)*	*VAT %*	*Excise (ECU/hl)*	*VAT %*	*Excise (ECU/hl)*	*VAT %*	*Excise (ECU/hl)*	*VAT %*
1 Aviation										
a) commercial international flights	ex.	ex.	ex.	ex.[6]	ex.	ex.	ex.	ex.[5]	ex.[7,8]	ex.
b) commercial domestic flights	ex.[7]	ex.[7]	ex.	ex.[6]	ex.	22	ex.[7]	ex.[5]	ex.[7,8] or 1.39/25	ex. 0/15
c) military aircraft and aircraft of public authorities	ex.	ex.	ex.	13	ex.	22	ex.	17.6[2]	1.39/25	0/15
d) business aviation	ex.[7]	ex.[7]	ex.	ex.[6] 13	ex.	22	ex. or **	17.6[2]	ex.[7,8] 1.39/25	ex. 0/15
e) private aircraft	ex.[7] or 20.35	25 (17)	20.24	13	ex.	22	0.76/15.57	17.6[2]	1.39/25	0/15
2 Navigation in home waters										
a) coastal	0	ex.	ex.	ex.	4.56[1]	ex.	ex.	ex.	0[8]	0
b) fishery	0	ex.	ex.	ex.	4.56[1]	22	ex.	ex.	0[8]	0
c) professional transport	0	25	ex.	ex.[9] 13	4.56[1]	22	ex. 2.31	ex. 17.6[2]	0[8]	0
d) pleasure boats (d = petrol/gas-oil)	20.35[11]/0	25	20.24/ 17.74	13	24.33/ 4.56[1]	22	22.14/ 12.45	17.6[2]	25.00[11]/ 1.39	15/0
3 Agriculture (gas-oil)										
a) in general	0	17	0[8,10]/0.67	13	ex.	22	2.31	17.6	1.39	0/15
b) horticulture	0	17	0[8,10]/0.67	13	ex.	22	2.31	17.6	ex.[8]	0/15
4 Auto-consumption										
a) refineries	ex.	—	ex.	—	ex.	—	ex.	—	ex.	—
b) petrochemical plants	ex.	—	ex.	—		—	ex.	—	ex.[12]	—
5 Public transport (gas-oil)										
a) railroad	0	17	ex.[8,13]	13	4.56[1]	22	2.31	17.6[2]	1.39	0
b) buses	8.36	25	ex.[8,13]	13	4.56[1]	22	12.45	17.6[2]	21.55	0
6 Diplomatic missions and consulates	ex.	ex.	ex.	ex.	ex.	ex.	ex.[14]	ex.[14]	ex.	ex.
7 International organisations	ex.	ex.	ex.	ex.	ex.	ex.	ex.	ex.	ex.	
8 Armed forces of another State	ex.	ex.	ex.	ex.	ex.	ex.	ex.	ex.	ex.	
9 Re-refined waste oils	0	17	21.13/ 100 kg	13	0	22	0	17.6	ex.	15

** *Editor's note:* In the EEC document no alternative figure is mentioned.

1. Complete drawback granted to professional consumers authorized to deduct VAT on these products.
2. Final consumers, even if normally entitled to deduct input VAT, may not deduct VAT charged on these products.
3. The preferential excise duty arrangements for light oils used as furnace fuel are subject to special authorization.
4. 15% as from 1 September 1981.
5. On condition that more than 80% of the company's activity takes place abroad or in the FOD.
6. On condition that the VAT-registered person's activity consists predominantly in international flights.
7. For flights to or from other countries.
8. Drawback.

TABLE 7 (cont.)

B. Reductions or exemptions of excise and/or VAT granted to certain consumer groups (cont.)

	GREECE		*IRELAND*		*ITALY*		*LUXEMBOURG*		*NETHERLANDS*	
Consumer groups	*Excise (ECU/hl)*	*VAT %*	*Excise (ECU/hl)*	*VAT %*	*Excise (ECU/hl)*	*VAT %*	*Excise (ECU/hl)*	*VAT %*	*Excise (ECU/hl)*	*VAT %*
1 Aviation										
a) commercial international flights	ex.		ex.	ex.	ex.	ex.	ex.	ex.	ex.	ex.
b) commercial domestic flights	ex.		ex.[7,8] or 2.59/23.93	ex. 0/10	ex.	18	ex.[7]	ex.[7]	ex.[7,8] or 1.16/19.01	ex. 18
c) military aircraft and aircraft of public authorities	ex.		2.59/23.93	0/10	ex. or 3.16/ 31.66	18	ex.	ex.	1.16/19.01	ex. 18
d) business aviation	?		ex.[7,8] or 2.59/23.93	ex. 0/10	ex. or 31.66	18	ex.[7]	ex.[7]	ex.[7,8] or 1.16/19.01	ex. 18
e) private aircraft	?		2.59/23.93	0/10	31.66	18	ex.[7] or 16.86	5(10)	ex.[7,8] or 1.16/19.01	ex. 18
2 Navigation in home waters										
a) coastal			0[8]	0	ex.	ex.	—	—	ex.	ex.
b) fishery			0[8]	0	ex.	ex.	0.60-0.92	5(10)	ex.	ex.
c) professional transport			0[8]	0	1.30	15	0.60-0.92	5(10)	ex.	18
d) pleasure boats (d = petrol/gas-oil)			23.93[11]/ 12.59	10/0	31.66/1.30	18/15	16.86/0.60-0.92	5(10)	19.01[11]/ 1.16	18
3 Agriculture (gas-oil)										
a) in general	1.12		2.59	0/10	ex.	6	0.61-0.92	5(10)	1.16	4
b) horticulture	1.12		ex.[8]	0/10	ex.	6	0.61-0.92	5(10)	1.16	3
4 Auto-consumption										
a) refineries		—	ex.	—	ex.	—	—	—	ex.	—
b) petrochemical plants		—		—	ex.	—	—	—	ex.	—
5 Public transport (gas-oil)										
a) railroad	—		2.59	0	ex.	15	0.60-0.92	5(10)	1.16	18
b) buses	—		2.59	0	1.30	15	4.84	5(10)	6.58	18
6 Diplomatic missions and consulates	ex.	ex.	ex.	ex.	ex.	ex.	ex.	ex.	ex.	ex.
7 International organisations			ex.		ex.		ex.		ex.	
8 Armed forces of another State			ex.		ex.		ex.		ex.	
9 Re-refined waste oils			ex.	10[4]	3.58	15	0.24	5	0	18

9. For passenger transport.
10. As motor fuel for tractors.
11. Exemption for vessels proceeding to destinations abroad.
12. If the energy is predominantly used for producing and processing mineral oils.
13. Exemption (drawback) wil be abolished in three steps up to 1983.
14. Subject to a quota.
15. Passenger transport is exempted. (*Editor's note:* In the EEC document there is no reference to this footnote in the text.)

French or German versions of Table 7 are available upon request.

UNICE and Taxation of Petroleum Products

On 2 February 1982 UNICE gave its opinion on document COM(81) 511 final of 9 September 1981, "Taxation of Petroleum Products" (Commission Communication to the Council)

1. SUMMARY OF THE COMMUNICATION TO THE COUNCIL

The Communication of the Commission is an argument in favour of joint efforts as regards taxes on oil. Although the Commission is concerned with economic policy, energy policy and public finances, the energy aspects are given as the main basis for the proposals made. The Commission sets out its views on various energy problems, especially as regards energy saving and substitution. The present incentives and achievements in the matter of energy saving and substitution are regarded as inadequate. In this connection the Commission argues that the level of prices of oil products should be raised by means of taxes, especially on heating oil and heavy fuel oil so as to accelerate the adjustment processes necessary.

2. ASSESSMENT OF THE COMMISSION'S PROPOSALS

The points made below refer essentially to energy policy, since this is the issue which looms largest in the Commission document. More attention and weight is naturally given here to industrial production and use aspects than to private consumption. Account is also taken of general economic policy considerations.

2.1. View of the Commission's diagnosis of energy problems

UNICE does not at all go along with the Commission thesis that petroleum product prices are not high enough to encourage saving and substitution and should therefore be raised by means of taxes.

The need for investment to cope with energy constraints is fully recognised by business and industry, which act accordingly wherever possible. The price mechanism has clearly played an effective part. A few figures, chosen among many others, illustrate this:

- whereas at the end of the 70s about 80% of the boilers ordered by German Industry were fuel burning, the figure had fallen to 40% (i.e. by half) by 1980. (The new trend being in the direction of (1) fuel/gas boilers using interruptable supplies of gas, and (2) boilers using residual heat or heat from waste);
- in German Industry the yearly consumption of heating oil (light and heavy fuels) dropped from 40 million TCE in 1973 to 25 million TCE in 1980. A further fall of 4 million TCE is expected in 1981, bringing down consumption to 21 million. These figures are a good reflection of Community figures as a whole.

Hence, even before considering the technical details of the Commission's proposals, there is the serious question of deciding whether the proposals are desirable and necessary at all.

2.2. Economic, technical and political problems created by the fiscal measures recommended

Irrespective of the issue whether the public authorities really need to add other general incentives to the price mechanism, one must admit that resort to taxation, at any rate, is not necessarily an effective way of coping with energy constraints.

This can be shown as follows:

a) as mentioned above, there may be serious technical obstacles to investment. For instance, many big firms which would be interested in converting to coal do not always have the extra space necessary for handling this sort of fuel. SMEs, on the other hand, might have financial problems. Account must also be taken of the procedures for obtaining authorisation, which can be long drawn out.

Increasing fiscal pressure does not help here. All it does is to erode the financial resources of consuming firms. Moreover, in the case of administered prices, tax increases often diminish the flexibility of pretax prices, with adverse effects on the financial situation of enterprises.

b) A deliberate increase in the price of oil products could, in times of supply difficulties, encourage the OPEC to hasten the upward movement in the price of crude oil.

c) The principle of a gradual elimination of fiscal exemptions enjoyed by oil refineries and petro-chemical concerns throughout the Community in respect of oil products used in production can be objected to on three counts:
- first of all, the oil and petro-chemical sectors are definitely among those which for 10 years have been making consistent efforts to save energy, and have obtained good results. No further incentive is needed here; far from encouraging investment, the use of taxes would hinder it, by diminishing the financial resources which could be devoted to investment in rational use of energy. Furthermore, this would penalize the use of residual petroleum products as a source of process heat, which is precisely a good example of rational use of energy;
- the elimination of the exemption would only exacerbate the competitive disadvantage suffered by the EEC relative to oil producing countries which are increasingly interested in on-the-spot refining. This would mean creating additional difficulties for a sector which already has serious adjustment problems;
- the general exemption situation at the moment has the advantage of providing perfect fiscal harmonisation at Community level.

d) In addition to this specific matter, it is obvious that the measures proposed would be detrimental to the competitiveness of European Industry as a whole compared with its international rivals, especially as regards chemicals. Further difficulties would be created on the employment level. The remedies proposed therefore are the carriers of even more serious diseases.

e) Quite apart from these outside considerations it must be said, too, that the views of the Commission on replacing petroleum products are not always very clear.

As regards heavy fuel, it must be remembered that electricity cannot be regarded as a good substitute if it is produced from oil products or natural gas.

Replacing heavy fuel by natural gas often is not the best solution either, especially in Member Countries that do not have natural gas deposits. There is a danger that one might replace dependence on oil by an equally harmful dependence on natural gas.

Furthermore, one cannot see the logic of introducing a hierarchy of energy prices so as to encourage substitution. In paragraph 2.4 it is stated that "more economical alternatives (than oil) already exist, and the use of oil should be discouraged here (production of power and heat)". If oil substitutes are more economical to use, and are offered in sufficient quantities, it is odd that it should be necessary to discourage firms from using oil. If, on the other hand, the oil substitutes are not yet offered in sufficient quantities, it would be dangerous to aim at increasing the price of oil so as to discourage its use as energy, since this would mean pushing up industrial production costs before the more economical factors were available.

It would be pointless, and dangerous, therefore, to try to reduce dependence on oil and to encourage the use of other energy sources before ensuring the necessary supplies of the substitute.

Among many sectors where the taxation envisaged would only add to production costs, one could quote inland waterway transport, where the possibilities of finding a substitute for diesel engines are practically nil. It is unthinkable that sectors hit by depression, such as the steel industry, should be saddled with extra costs for the transport of raw materials and finished products. This applies, of course, to other industrial sectors too.

2.3. Taxation as a means of smoothing price changes

The Commission considers that price policy should provide consumers with indications, as clear and as far-sighted as possible, as to future price developments, and that, in this context, taxes on petroleum could help to ensure more regular adjustments in oil product prices.

UNICE does not find this argument very convincing. The regular tax adjustment proposed would imply clear and reliable forecasts as to the quantities of petroleum available, movements in the price of other energies, the shape of demand, political factors and technical progress. A great deal has been written to show the fallibility of energy forecasting and it would be dangerous for the economy to be dependent on guidelines provided by a central forecasting body.

The Commission suggests that tax adjustments should aim at preventing temporary falls in price, possibly through the building up of financial reserves in time of price falls, which could be used to delay the next rise, or spread it over time. Industry does not wish to lose the benefit of any fall in price that might occur. Furthermore, as to the question whether price movements should be carefully evened out, the point could be made that the instability of the petroleum market is a strong argument for dropping this source of energy, wherever this is technically possible.

2.4. Conclusion: Which tax harmonisation strategy?

The general discussion about tax harmonisation in the Community is not new, and UNICE has, on several occasions, expressed support for moves in this direction, so long as the approach was across the board and neutral.

In this conection UNICE would like to make a few suggestions which, necessarily modest, call for more thorough studies with public authorities.

a) Motor fuel taxation should be studied in the context of the overall taxation of vehicles, which includes a series of taxes (VAT on purchase, road taxes, etc.), which must also be taken into account for achieving real harmonisation.

b) If one wishes to make progress in the matter of harmonising taxes on heating fuels (gas-oil and fuel), one must firmly keep in mind the fact that taxes on heating oil constitute only a small proportion of taxes on oil products generally (7.3% of receipts). The tax effect on the selling price of these products is limited too. It might therefore be simplest to limit taxation to motor fuels, leaving industrial fuels exempt througout the Community, which would mean harmonisation.

c) This zero level tax harmonisation as regards industrial fuels would only make sense if all energy products used by industry were looked at from the angle of fiscal harmonisation. The fact is that, in a given country, users may find a favourable tax situation as regards some energy products, and an unfavourable one as regards others. Altering the tax situation of one energy source could upset the prevailing pattern and balance. In general, it must be realised that intra-Community differences as regards taxes on energy can have a compensatory effect by off-setting other intra-Community differences in the matter of productivity, interest rates, wages costs, etc.

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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INHALTSVERZEICHNIS

SOMMAIRE

Federal Taxation of Foreign Governments, International Organizations, and Their Employees in the United States

By William W. Chip and Steven S. Snider *

I. INTRODUCTION

Citizens and residents of the United States, and certain non-resident aliens as well, are subject to a bewildering variety of U.S. taxes imposed at the federal, state, and local levels. The federal government imposes taxes on income, gifts, transfers by reason of death, and certain other items not considered in this article. All states impose taxes on income or sales or both. Most cities and counties tax the ownership of real and even personal property and some, such as New York City, impose an income tax as well. The many outposts of foreign governments in the United States and the numerous international organizations that are located there, and of course the employees of both, are naturally interested in the extent to which they are subject to this complicated tax regime. Because the federal taxes are usually the highest, and because the state and local rules often follow the federal treatment, the focus of the potential taxpayer's concerns and of this article is on taxation at the federal level.

A decade ago this *Bulletin* published an article that thoroughly explored the historical background of U.S. income taxation of foreign governments, international organizations, and their employees and described the state of the law at the time.[1] Since then, new regulations have been issued concerning the income taxation of official foreign entities, while legislative, judicial, and administrative developments have taken place that will have a significant impact on the income tax status of their employees. An updated review of these topics therefore appeared to be in order. In addition, due to expanding investment by alien individuals in U.S. property, attention to estate and gift taxation of international organization and foreign government employees is also timely.

Contents

II. TAXATION OF FOREIGN GOVERNMENTS AND INTERNATIONAL ORGANIZATIONS

Section 892 of the U.S. Internal Revenue Code provides that the investment income of "foreign governments or international organizations" from United States sources shall be exempt from United States income taxation. In contrast, income derived from "commercial activities" within the United States is not exempt.[2] Accordingly, whether a foreign entity is taxable on its income from United States sources will be determined by (1) whether the entity falls within the statutory definition of "foreign government" or "international organization" and (2) whether the income from United States sources is derived from "commercial activities" or from investment.

A. Foreign governments

The term "foreign government" is not defined by the Internal Revenue Code, but is defined in the regulations under section 892. The regulations state that the term "foreign government" applies to all "integral parts or controlled entities of a foreign sovereign".[3] The terms "integral part" and "controlled entity" are then separately defined.

* Of Ivans, Phillips and Barker, Washington D.C.

1. Rendel, *United States Income Taxation of Foreign Governments, International Organizations and their Employees,* 26 Bull. Int'l Fiscal Doc. 448 (1972).
2. Treas. Reg. § 1.892-1(a)(3)(i).
3. Id. § 1.892-1(b)(1).

An "integral part" of a "foreign sovereign" is defined in the regulations as any body, however designated, that constitutes a governing authority of a foreign country.[4] Prior to issuance of the regulations, the Chilean *Corporación de Fomento de la Producción* had been held by the U.S. Tax Court to be an "integral part" of the Chilean government.[5] In addition, numerous foreign cultural organizations have received rulings from the Internal Revenue Service that they qualify as "integral parts" of a foreign sovereign.[6]

A "controlled entity" of a foreign sovereign is defined as an entity juridically separate from a foreign sovereign that meets all of the following requirements: (1) it is wholly owned and controlled by a foreign sovereign, directly or through other "controlled entities"; (2) it is organized under the laws of the foreign sovereign that owns it; (3) its net earnings are credited to its own account or to other accounts of the foreign sovereign without inuring to the benefit of any private person; and (4) its assets vest in the foreign sovereign upon dissolution.[7] Examples of entities that have been found by the Internal Revenue Service to be "controlled entities" are certain foreign central banks of issue,[8] the Foreign Currency Board of an unnamed country,[9] an export-import loan authority,[10] a government-owned hospital,[11] an orchestra association,[12] and a tourist board.[13] The regulations specifically provide that a pension trust for foreign government employees is a "controlled entity" if the trustees are appointed by the foreign government and the pension plan provides for definitely determinable benefits.[14] Favorable rulings have been issued to several such trusts.[15] Even if they do not fall within the special pension trust provisions of the regulations, government sponsored welfare benefit programs may qualify as "integral parts" or "controlled entities" of a foreign sovereign. An example is the favorable ruling issued in 1979 to a foreign "fund" providing "sickness, injury, bereavement and old age" benefits, not limited to government employees.[16]

Entities owned and controlled by more than one foreign sovereign are not considered "controlled entities",[17] and the East Caribbean Currency Authority and an unnamed "fund" were each ruled not to be a "controlled entity" on this basis.[18] A number of governments may, however, collectively constitute a "foreign government".[19] The test is whether the group as such is empowered to exercise, independently, substantial governmental powers binding the member governments.[20] Under this test the European Economic Community, the European Coal and Steel Community, and the European Atomic Energy Community were held to be "foreign governments".[21]

B. International organizations

The term "international organization", unlike the term "foreign government", is defined in the Internal Revenue Code. Section 7701(a)(18) of the Code defines "international organization" as any "public international organization" afforded the privileges of the International Organizations Immunities Act. The latter Act is codified at sections 288 to 288i of Title 22 of the U.S. Code. Under section 288 the entities afforded the privileges of the Act are "public international organizations" (1) in which the United States participates pursuant to any treaty, or otherwise under the authority of Congress, and (2) which shall have been designated by the President as qualifying for such privileges through an Executive Order. The forty-six organizations that have to date been so designated are listed in the appendix to this article.

C. Commercial activities

As noted above, neither "foreign governments" nor "international organizations" are exempt from tax on their income derived from "commercial activities". Any activity conducted in the United States of the sort ordinarily conducted with a view towards production of income is a "commercial activity" unless the regulations under section 892 specifically provide otherwise.[22] The following activities are listed in the regulations as not constituting "commercial activities": investing in corporate shares, even though they represent a controlling interest; investments in bonds, other securities, loans, net leases, or unproductive land; holding bank deposits; presenting amateur athletic exhibitions; giving cultural performances; purchasing goods for use of the foreign sovereign; engaging in activities not constituting a trade or business in the United States; and engaging in activities not customarily carried on for profit.[23]

III. REMUNERATION FROM A FOREIGN GOVERNMENT OR AN INTERNATIONAL ORGANIZATION

Section 893 of the Internal Revenue Code provides that the wages, fees, or salary of any alien employee of a "foreign government" or "international organization" received as compensation for services to such government or organization is exempt from United States taxation. If the alien is employed by a foreign government, the character of the services performed must be similar to those provided by employees of the U.S. government outside the United States, and the foreign government must grant an equivalent exemption to employees of the U.S. government.[24] Although the law requires that the

4. Id. § 1.892-1(b)(2).
5. *Vial v. Commissioner*, 15 T.C. 403 (1950).
6. Letter Ruls. 8037112, 8012078, 7934045, 7849014, 7806073, 7806072.
7. Treas. Reg. § 1.892-1(b)(3).
8. Rev. Rul. 75-298, 1975-2 C.B. 290; Letter Ruls. 7837006, 7833050.
9. Rev. Rul. 76-329, 1976-2 C.B. 223.
10. Letter Rul. 8101060.
11. Letter Rul. 8038032.
12. Letter Rul. 7934119.
13. Letter Rul. 7811023.
14. Treas. Reg. § 1.892-(b)(4).
15. Letter Ruls. 8020139, 7841076, 7804046.
16. Letter Rul. 7951046.
17. Treas. Reg. § 1.892-1(b)(3).
18. Rev. Rul. 77-482, 1977-2 C.B. 242; Letter Rul. 7826098.
19. Rev. Rul. 68-309, 1968-1 C.B. 338.
20. Rev. Rul. 77-41, 1977-1 C.B. 226.
21. Rev. Rul. 68-309, 1968-1 C.B. 338.
22. Treas. Reg. § 1.892-1(c)(1).
23. Id. § 1.892-1(c)(2).
24. I.R.C. § 893(a)(2), (3).

State Department shall certify to the Treasury that these two requirements have been met in the case of each foreign government,[25] we are aware of only two cases in which an alien employee of a foreign government was taxed because no such certification was issued with respect to his government.[26]

For purposes of section 893, consular or other officers, as well as non-diplomatic representatives, are treated as foreign government employees.[27] However, former employees of foreign governments and international organizations are not protected by section 893.[28] For example, the Internal Revenue Service has ruled that a former employee of a foreign government was taxable on his pension from that government.[29]

An alien employeee of a foreign government or international organization that wishes to obtain or retain U.S. immigrant status must file a waiver of any exemptions under the law deriving from his occupational status.[30] In most cases, the filing of such a waiver will void the application of section 893 to the alien, and he will become taxable on remuneration from his foreign government or international organization employer.[31] The waiver, however, will not eliminate the exemption if it is based upon a treaty with the foreign government or the articles of agreement of the international organization.[32]

The term "foreign government" is not defined in section 893 or the regulations thereunder, but the regulations under section 892 provide that the term "foreign government" has the same meaning for purposes of section 893 as it does for purposes of section 892.[33] Thus, the principles, discussed in the preceding section, that determine whether an entity itself qualifies for tax exemption as a "foreign government" should also determine whether wages, fees, and salaries paid by the entity to its alien employees are also exempt from taxation. In the case of "international organizations", the regulations again make clear that the same criteria apply for purposes of both sections 892 and 893.[34]

IV. THE DETERMINATION OF RESIDENCY STATUS

The taxation of income which is unrelated to a foreign government or international organization employee's official duties will depend upon whether the employee is a resident or non-resident of the United States. If the employee is a non-resident alien, he will be taxed on fixed and determinable income from U.S. sources, such as rent from U.S. property and dividends and interest from U.S. corporations, at the rate of 30% of the gross amount of such income.[35] In addition, he will be subject to tax at the rate of 30% on net U.S. capital gains, other than gains from the sale of U.S. real estate, if he is present in the U.S. for 183 days or more during the taxable year in which such gains are realized.[36] Capital gains realized from the sale of U.S. real estate (or the sale of stock in a corporation primarily holding U.S. real estate) are subject to tax on essentially the same basis as they are to a U.S. resident, except that a minimum amount of tax, generally equal to 20% of the gain, must be paid.[37]

If the employee is a resident alien, he will be subject to U.S. income tax, according to the progressive schedule of rates applicable to U.S. citizens, on all of his worldwide income (except for wages, fees, and salaries from his foreign government or international organization employer). Foreign income tax paid with respect to foreign source income is usually creditable against the U.S income tax on such income.[38]

Under the income tax regulations, all aliens are presumed to be non-resident aliens for income tax purposes.[39] The regulations also provide, however, that this presumption may be rebutted by acts showing an intention to acquire residence or by a stay of such an extended nature as to constitute the alien a resident.[40] A definite intention to acquire residence is apparently manifested by the absence of any definite intention concerning the length and nature of the alien's stay in the United States,[41] and a stay of one year is of "such an extended nature" to create the presumption of residence.[42] In short, the alien is a resident unless he has a definite intention to leave after accomplishing a purpose that does not require an extended stay. If he stays more than one year the burden of proving his intention shifts from the Internal Revenue Service to the alien.

The determination of the alien's intentions is based solely on objective manifestations of such intentions. No statement made to the immigration authorities, nor any document issued by a foreign government evidencing the establishment of residence abroad, can guarantee that an individual will be accorded non-resident status. Instead, such factors as the length of his stay in the United States; the nature, extent, and reasons for his temporary absence from a foreign home; his visa classification; the size and nature of his physical dwelling in the United States; and the extent of his integration into U.S. society will determine whether an alien is a U.S. resident.

An alien whose stay in the United States is limited to a "definite period" by the immigration laws is considered under the income tax regulations to be a non-resident "in the absence of unusual circumstances".[43] In practical terms, therefore, visa classification should usually be the most significant factor in determining residence, al-

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25. Id. § 893(b); Treas. Reg. § 1.892-1(b).
26. *Ratarra v. Commissioner*, 40 T.C.M. 1119 (1980) (Thailand); Letter Rul. 7929044 (Rhodesia).
27. Treas. Reg. § 1.893-1(a).
28. Rev. Rul. 56-44, 1956-1 C.B. 319.
29. Id. However, under a number of income tax treaties currently in force, foreign government pensions are not subject to U.S. taxation.
30. 8 U.S.C. § 1257(b)(19).
21. Treas. Reg. § 1.893-1(a)(5), (b)(4).
32. Id. § 1.893-1(c); Rev. Rul. 75-425, 1975-2 C.B. 291; Letter Rul. 7935001.
33. Treas. Reg. § 1.892-1(f)(1).
34. Id. §§ 1.892-2(a); 1.893-1(b)(3).
35. I.R.C. §§ 871(a)(1)(A), 861(a)(1), (2), (4). The 30% tax on corporate dividends and interest is not payable if less than 20% of the corporation's gross income is from U.S. sources. Id. § 861(a)(1)(B), (2)(A).
36. Id. § 871(a)(2).
37. Id § 897(a).
38. See I.R.C. § 901(a).
39. Treas. Reg. § 1.871-4(b).
40. Id. § 1.871-4(c)(2)(iii).
41. Id. § 1.871-2(b).
42. Rev. Rul. 69-611, 1969-2 C.B. 150.
43. Treas. Reg. § 1.871-2(b).

though it is not entirely clear what the regulations mean by a "definite period". D-1 (alien crewman) visas have been held to limit residence to a "definite period" within the meaning of the regulations,[44] but there is otherwise no authoritative guidance. In our view, visas such as B (visitor), J (exchange student or scholar), and L (intracompany transferee) visas, which limit the holders' stay to 12 months or less,[45] are probably "definite period" visas. Visas such as F (student) visas and most G (international organization employee) visas, which limit the holders' stays only to the time they continue pursuing the activities on which their status is based,[46] may not be "definite period" visas.

An alien seeking to retain his non-resident status should also consider the following possibilities: leasing accommodations in the U.S. for short periods of time rather than purchasing them; continuing to own and occupy his home abroad; maintaining an office and substantial business operations abroad; not owning a car in the U.S. and not applying for a U.S. driver's license; not belonging to clubs and churches in the U.S., but continuing affiliations with and contributions to such groups abroad; not maintaining substantial savings or checking accounts in the United States; using traveler's checks and international credit cards rather than local charge accounts for purchases in the U.S.; and continuing to designate a foreign place of residence or domicile in legal documents and in formal correspondence. Although it is not necessary for an alien to comply with all of these recommendations in order to qualify as a non-resident, the more closely they are followed, the stronger will be his case for treatment as a non-resident. Unfortunately, the Internal Revenue Service will not rule in advance on the resident status of an alien if the determination depends on facts that cannot be confirmed prior to the end of the taxable year.[47]

V. ESTATE AND GIFT TAXES

Residents of the United States are taxable on the transfer of property by gift or bequest. However, a $10,000 per-donee, per-annum exclusion from the gift tax,[48] combined with a lifetime gift and estate tax credit of $62,800,[49] means that substantial amounts of property must be transferred before any gift or estate tax is actually payable. Resident aliens are taxable on gifts and bequests of property wherever situated within or without the United States. Non-resident aliens, by comparison, are taxable only on gifts and bequests of property situated within the United States.[50] Generally, for both gift and estate tax purposes, stock in U.S. corporations and the debt obligations of U.S. persons are deemed to be situated within the United States, while stock in foreign corporations and the debt of foreign persons are deemed to be situated without the United States.[51]

The test of residence for estate tax purposes is whether the individual is "domiciled" in the United States at the time of death.[52] In the United States the term "domicile" connotes a more permanent attachment than the term "residence". It is determined, not by length of stay, but by whether one has a "definite present intention" to depart at a later date.[53] Employees of foreign governments and international organizations who wish to avoid U.S. estate and gift tax on their overseas property must take care to preserve their foreign domiciles because the Internal Revenue Service has recently ruled that holding a G-4 or A-1 visa is *not* conclusive evidence that a U.S. domicile has not been established.[54] A number of countries have Estate and Gift Tax Treaties with the United States that may bear on a particular individual's liability for these taxes.[55] Nationals of these countries contemplating large gifts or bequests should examine the pertinent provisions of applicable treaties to ascertain their rights.

VI. SALE OF PERSONAL RESIDENCE

Because of the possibility for substantial appreciation and the very generous deductions allowed homeowners against otherwise taxable income, many U.S.-based employees of foreign governments and international organizations will purchase one or more personal residences during their stay in the United States. In our experience the consequences arising from the sale of their personal residences is the tax question most commonly faced by such employees.

As noted above in Part IV, a non-resident is taxable on essentially the same basis as a resident on gain from the sale of real estate, and this rule also applies to the sale of a personal residence. Gain from the sale of a personal residence is "capital gain" rather than "ordinary income". This is principally significant if the residence has been owned for more than one year, in which case the gain is "long-term capital gain". In computing his taxable income, an individual may deduct 60% of any long-term capital gain.[56]

The tax laws provide relief to an individual who sells his personal residence and purchases a new residence during the 24-month period preceding, or the 24-month period following, the sale of the old residence.[57] If the individual buys a new residence within the prescribed period, he is

44. See *Sanford v. Commissioner*, 27 T.C.M. 266 (1968); Tech. Adv. Mem. 8135028.
45. See 8 C.F.R. § 214.2(b), (j)(1), (l)(1), (3)(17).
46. See id. § 214.2(f)(2), (g)(1).
47. Rev. Proc. 80-38, 1980-2 C.B. 771.
48. I.R.C. § 2503(b).
49. Id. § 2010(a). This credit will be increased in phases after 1982 until it reaches $155,800 in 1986. Id. § 2010(b). The effect of a $155,800 credit is that $600,000 of assets may be gratuitously transferred free of estate and gift tax.
50. Id. §§ 2103, 2501. The rules concerning estate and gift taxation of non-resident aliens have recently been outlined in detail in Schlinkert, "Estate Planning for the Nonresident Alien", Tax Management Int'l J., Aug., 1981, at 3. Another recent article on the subject, focusing on real estate investment, is Mene, "Estate Planning for Nonresident Aliens", 59 Taxes 617 (1981).
51. I.R.C. §§ 2104(a)(c), 2511(b); Treas. Reg. § 25.2511-3(b).
52. Treas. Reg. § 20.0-1(b)(1).
53. Id.
54. Rev. Rul. 80-363, 1980-2 C.B. 249 (G-4 visa); Tech. Adv. Mem. 8137027 (A-1 visa).
55. Countries with which the United States has Estate Tax Treaties are: Australia, Belgium, Canada, Finland, France Greece, Ireland, Italy, Japan, the Netherlands, Norway, South Africa, Switzerland and the United Kingdom. The treaties with Australia, France, Japan and the United Kingdom also extend to gift taxes.
56. I.R.C. § 1202(a).
57. Id. § 1034(a).

taxable on gain from the sale of his old residence only to the extent the "amount realized" from the sale of his old residence exceeds the "cost" of his new residence. For this purpose, the "amount realized" from selling the old residence is reduced by sales commissions, legal fees, and other costs incident to selling the old residence, including certain expenses for work performed on the old residence to assist in its sale.[58] Conversely, the "cost" of the new residence includes fees, commissions, and other expenses incurred in acquiring it, unless they are deducted for U.S. income tax purposes.[59] Mortgage "points", for example, may qualify as interest and, if they do, are deductible in computing taxable income.[60]

This relief from tax on the sale of a personal residence appears to be available even if the individual acquires his new residence outside the United States, provided he was a resident alien at the time he sold his old residence.[61] Indeed, if the alien moves outside the United States, the period during which he must acquire his new residence is extended from two to four years.[62] If, however, the alien was a non-resident at the time he sold his old residence in the United States, relief from taxation is not available unless the new residence is also located in the United States.[63]

Another form of tax relief for homeowners is an exclusion from income of up to $125,000 of gain from the sale of a personal residence if the homeowner is at least 55 years old at the time of sale.[64] A taxpayer may elect this exlusion with respect to only one sale in his lifetime.[65]

VII. U.S. INCOME TAX RETURN FILING REQUIREMENTS

A non-resident alien is required to file a return on Form 104NR if he was engaged in a trade or business in the United States at any time during the taxable year,[66] he has elected to report income from real property on a net basis,[67] or there was underwithholding from U.S. source fixed or determinable annual or periodical income, such as interest or dividends.[68] Employment in the United States with a foreign government or international organization presumably constitutes a U.S. trade or business, and employees of these organizations should therefore file a return unless their gross income, exclusive of exempt wages, is less than $1,000.[69]

A non-resident alien married to a U.S. citizen or resident may elect to be taxed as a resident alien in order to file a joint return with a citizen or resident spouse and thereby qualify for the generally lower rates applicable to individuals filing joint returns.[70] An alien employee of a foreign government or international organization would not subject his remuneration to taxation by electing to be taxed as a resident, because the exemption of such income from tax under section 893 is based on citizenship rather than residence.[71] Under regulations recently proposed by the Internal Revenue Service, a non-resident alien who makes the election in order to file a joint return may not claim to be a non-resident for purposes of any U.S income tax treaty.[72] Although the election may later be revoked, once revoked it may never be made again between the same individuals.[73] The election should not, therefore, be made without careful consideration of the couple's future tax planning needs.

If an alien changes his status from resident to non-resident during the taxable year, he may be taxed "as though his taxable year were comprised of two separate periods", and the tax liability for each period will be computed under its own set of rules.[74] In determining a dual-status taxpayer's tax rate for the year, however, all income must be taken into account, including any part earned during the period of non-residence.[75] A dual-status taxpayer's exemptions for himself, his spouse and dependents may not exceed the taxable income for the period he is a resident alien.[76] If the dual-status taxpayer is a resident alien at the end of the taxable year, he may elect to be taxed as a resident alien for the entire year.

To file as a dual-status taxpayer, the employee should file Form 1040 and write across the top of the return "Dual-Status Return". A separate schedule must be attached to his return to show the income for the part of the year he was a non-resident. Form 1040NR may be used as a separate schedule, but the employee should mark "Statement" across the top thereof.[77]

If the U.S. residency is established after the commencement of a calendar year and the individual does not want to subject to U.S. taxation income from U.S. sources earned during the portion of the year he was a non-resident, he may adopt a fiscal year. If he has not previously filed as a non-resident on a calendar year basis, he may adopt a fiscal year without obtaining the perior approval of the Internal Revenue Service so long as he maintains books and records that "reflect income adequately and clearly on the basis of an annual accounting period".[78] The establishment and maintenance of adequate books and records may not be delayed beyond the end of the first fiscal year.[79]

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58. Treas. Reg. § 1.1034-1(b)(4).
59. Id. § 1.1034-1(b)(7).
60. Rev. Rul. 69-188, 1969-1 C.B. 54; see also I.R.C. § 461(g)(2) (year of deduction).
61. Rev. Rul. 71-495, 1971-2 C.B. 311.
62. I.R.C. § 1034(k).
63. Id. § 897(a).
64. Id. § 212(a), (b).
65. Id. § 121(b)(2).
66. Treas. Reg. § 1.6012-1(6)(1)(i).
67. Id. § 1.6012-1(b)(2).
68. Id.
69. Section 1.6012-1(b)(1)(i) of the regulations states that if a non-resident alien has no gross income for the taxable year, he is not required to complete the return schedules but must attach a statement to the return indicating the nature of any exclusions claimed and the amount of such exclusions to the extent such amounts are readily determinable. The Code, however, clearly provides that an income tax return need not be filed by an individual, including a non-resident alien, whose gross income is less than $1,000. See I.R.C. § 6012(a)(1).
70. I.R.C. § 6013(g).
71. Id. § 893(a)(1); Leter Rul. 7839026.
72. Prop. Treas. Reg. § 1.6013-6(a)(2)(v).
73. I.R.C. § 6013(g)(4)(A), (6).
74. Treas. Reg. § 1.871-13(a).
75. Id.
76. Treas. Reg. § 1.871-13(d)(2).
77. I.R.S. Publication 519 at 6.
78. I.R.C. § 441(g); Treas. Reg. § 1.441-1(g)(3); Rev. Rul. 80-352, 1980-2 C.B. 160; *Godson v. Commissioner*, 5 T.C.M. 648 (1946). Cf. *MacLean v. Commissioner*, 73 T.C. 1045 (1980) (taxpayer required to use calendar tax year because he did not keep adequate books and records for fiscal tax year filing as required by I.R.C. § 441(g)).
79. *Freudman v. Commissioner*, 10 T.C. 775 (1948).

From a tax standpoint, adoption of a fiscal year appears very desirable. The practical problems of this approach, however, may outweigh the tax benefits. The employee's adoption of a fiscal year may result in greater scrutiny by the Internal Revenue Service than if the employee adopted a calendar taxable year. In addition, the filing of a return on a fiscal basis will require greater efforts by the employee since certain information statements, customarily available at the end of a calendar year, may be unavailable during the year.

APPENDIX

African Development Fund.
Asian Development Bank.
Caribbean Organization.
Customs Cooperation Council.
Food and Agriculture Organization.
Great Lakes Fishery Commission.
Inter-American Defense Board.
Inter-American Development bank.
Inter-American Institute of Agricultural Sciences.
Inter-American Statistical Institute.
Inter-American Tropical Tuna Commission.
Intergovernmental Maritime Consultive Organization.
Interntional Atomic Energy Agency.
International Bank for Reconstruction and Development.
International Centre for Settlement of Investment Disputes.
International Civil Aviation Organization.
International Coffee Organization.
International Cotton Advisory Committee.
International Cotton Institute.
International Development Association.
International Fertilizer Development Center.
International Finance Corporation.
International Hydrographic Bureau.
International Joint Commission – United States and Canada.
International Labor Organization.
International Maritime Satellite Commission.
International Monetary Fund.
International Pacific Halibut Commission.
International Secretariat for Volunteer Service.
International Telecommunication Union.
International Wheat Advisory Committee (International Wheat Council).
Lake Ontario Claims Tribunal.
Organization of African Unity (OAU).
Organization of American States (including Pan American Union).
Pan American Health Organization.
South Pacific Commission.
United International Bureaux for the Protection of Intellectual Property (BIRPI).
United Nations.
United Nations Educational, Scientific, and Cultural Organization.
Universal Postal Union.
World Health Organization.
World Intellectual Property Organization (WIPO).
World Meteorological Organization.

Conference Diary

JULY 1982

Practising Law Institue: International estate planning (including: Taxation of non-resident alien in the U.S.; The use of foreign situs trusts). New York City (U.S.A.), July 22-23 (English).

SEPTEMBER 1982

36th Annual Congress of I.F.A.: I. The tax treatment of interest in international economic transactions. II. Taxation of payments to non-residents for independent personal services. Montreal (Canada), September 12-16 (English, French, German, Spanish).

Confédération Fiscale Européenne (C.F.E.): Third European Congress of Tax Consultants (including: State of tax harmonisation in Europe; The application of wealth taxes and taxes arising on death to foreign assets and liabilities; The practical application of international tax provisions (working groups)). Aachen (Germany), September 30 to October 2 (English, French, German, Spanish).

OCTOBER 1982

Management Centre Europe: International Tax Management (including: Inter-company pricing of goods; inter-company licensing; service fees; inter-company loans; handling of disputes between tax administrations) (Seminar). Nice (France), October 11-12 (English).

Management Centre Europe: Taxation of International Group Companies and Branches (including: Taxation of branches and subsidiaries; taxation of shareholders; domestic and tax treaty "anti-avoidance" measures) (Seminar). Brussels (Belgium), December 2-3 (English).

OCTOBER 1983

37th Annual Congress of I.F.A.: I. Tax avoidance/tax evasion. II. International problems in the field of turnover taxation. Venice (Italy), October 10-15 (English, French, German, Spanish).

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Confédération Fiscale Européenne (C.F.E.): Secrétariat Général, Postfach 1340, Dechenstrasse 14, D-5300 Bonn 1 (Federal Republic of Germany).

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.

Practising Law Institute: 810 Seventh Avenue, New York, N.Y. 10019. (U.S.A.).

The Dynamics of Property Tax Delinquency in the Philippines – A Case Study –

by Milwida M. Guevara *

Evasion is a serious problem in the collection of property tax in the Philippines. From 1974 to 1979, local authorities were only able to collect an average of 51% of the rates due.[1] This situation has precluded the property tax from becoming a buoyant source of revenue for local governments.

In accounting for this problem, local authorities blamed their non-use of legal sanctions in the collection of delinquent taxes on the lack of adequate personnel in the office of the treasurer and the poverty of the taxpayers (NTRC 1974; NTRC 1980).

Another angle was brought up in a study of the same problem by a team from Syracuse University, United States. They noted instances where a land parcel in a local unit in the Philippines was listed as belonging to more than one owner. Apparently this was caused by the failure of assessors to monitor land transfers.

These findings notwithstanding, there is reason to believe that evasion is not a mere product of a weak tax administration. Other studies substantiate the fact that evasion is multi-dimensional in character.

In analyzing delinquency in property tax in Pittsburgh, Pennsylvania (U.S.A.), Sternlieb and Lake (1976) found out that a number of the delinquent taxpayers were old, retired and with incomes below the median income in Pittsburgh 6 years before their study. They also tended to be clustered in the lower-status labourer and service occupation categories.

Vogel (1974), Spicer and Lundstedt (1976) and Lewis (1979), on the other hand, all deal with the importance of attitude in tax compliance.

Vogel (1974) investigated the variables related to attitudes favourable to tax evasion. Education, for example, was found to have an inverse relationship to the predisposition to tax evasion while the awareness of illegal opportunities exerted a positive influence on the said tendency.

In the same vein, Spicer and Lundstedt (1976) found that tax resistance is more likely when a taxpayer perceives that his terms of trade with the government are inequitable and if he personally knows many tax evaders. Their study gave no strong support to the theory of a relationship between tax resistance and the perceived severity of sanctions.

Lewis (1979), in his study of 200 male taxpayers in Bath, England, concluded that income and the amount of tax a person pays have a significant influence on his views of taxation. For example, he found out that people with incomes above £6,000 a year felt that tax avoidance is fair while people with incomes below that level felt otherwise.

Considering the above findings, our intention was to investigate the nature, extent and causes of property tax delinquency in a typical local authority in the Philippines. The study was anchored on the framework that property tax delinquency is affected by several variables as shown in the following model:

$$Y = F(X_1, X_2, X_3, X_4, X_5)$$

where:

Y = property tax delinquency index

X_1 to X_5 = characteristics of the delinquent taxpayer as follows:

- X_1 = income
- X_2 = educational attainment
- X_3 = tax ethics
- X_4 = perception of equity in the property tax system
- X_5 = perception of the probability of detection of delinquency in the property tax payment.

The length of delinquency in terms of the number of years was taken as the index of property tax delinquency. Actual data were used for income and educational attainment while the attitude of the taxpayer towards his tax obligation was measured by his score on a Likert-type attitude scale constructed for the purpose.

Prior to the survey, the researcher went over the 7,652 tax declarations in Obando,[2] Philippines by hand. Some

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1. *Editor's note:* "Rates is the British term for local taxes.
2. Obando is a municipality in the province of Bulacan. A municipality is the second smallest form of local government in the Philippines. Several barangays make up a municipality. A number of municipalities comprise a province. Provinces and cities make up the country.

1,603 taxpayers were identified as delinquent. From these, a 5% tapering sample was chosen through systematic random sampling. Preliminary interviews were conducted with delinquent taxpayers in order to construct the attitude scale which was subjected to an item analysis. The questionnaires were administered using an interview by a team of 6, including the researcher, for 4 days. The data were analyzed using the multiple regression scheme. The variables with very small estimated coefficients were eliminated in the final model which was used. Variables which because of their related nature may exert the same effect on income, such as income and level of education, were tested for auto-correlation. To measure the significance of the independent variables, the t-statistic was computed for each estimated coefficient.

Results of the study

After reorganizing the data from the survey of delinquent taxpayers, the following profile emerged:

Over half (64%) have incomes less than ₱1,000[3] which is below the 1980 national per capita income. Among other reasons, this is because about 40% of the people questioned lack regular employment.

A quarter of the respondents have only finished elementary education. A significant number thus have had only 6 years or less of schooling.

The majority of the respondents (57%) are 50 years and above. A number of them are retired employees and cases of sick and physically handicapped taxpayers were noted.

Most of the delinquent properties are residential in nature and have assessed values from ₱1,000 to less than ₱5,000. Delinquency in commercial lands is concentrated on properties with an assessed value of over ₱5,000 while the core of the delinquency problem in agricultural lands is in properties which have assessed values of less than ₱1,000. The average length of delinquency is 4 years.

A preliminary analysis of the completed questionnaires tended to show great variability in the responses of the different samples. To minimize this, the responses were analyzed by land-use of the property owned by the delinquent taxpayer. The estimated coefficient for income was found to be so small that it was dropped from the final equation that was used. The apparent inference – that income does not exert any significant influence on property tax delinquency – should, however, be made with caution as the study acknowledges a limitation on the income data. Respondents were directly asked the amount of their income, including non-cash income. Considering the reluctance of Filipinos to reveal their true income, it is probable that the data on income were inaccurate.

To check the existence of multi-colinearity among the attitude indices, the coefficient of correlation (r) was computed. The relationship between equity and tax ethics was found significant at the .05 level so that they were not put together in one equation. Two equations were thus used:

$$Y_1 = a + bx_2 + bx_3$$

$$Y_2 = a + bx_2 + bx_4 + bx_5$$

The estimated coefficients of the regression equations are shown below. Some significant coefficients are noted in the estimated relationships for the behaviour of landowners of commercial and industrial properties and employed landowners of residential and agricultural land.

Multiple regression results

Variables/Land-use	*Industrial*	*Agricultural*	*Residential*
Education (b_2)	– .9768*	–.7340*	–.3079
Ethics (b_3)	– .2197*	–.0169	–.0924
Equity (b_4)	–1.193 *	.2128	–.2866*
Probability of detection (b_5)	.5966*	–.1489	–.1821
R^2	.8876	.2068	.4262
R	.9421	.4546	.6529
SE	.5512	1.924	1.622

* Significant at the .05 level of confidence.

For delinquent taxpayers owning commercial and industrial properties, an inverse relationship was noted between education and property tax delinquency; tax ethics and delinquency; and the perception of equity and delinquency. This means that delinquency is more likely when taxpayers are less educated and when they are less disposed towards tax compliance. Likewise, delinquency is associated with the perception that the tax system is inequitable. The feeling of inequity was determined by the strong agreement of the taxpayer with the following statements:

1. From what I have heard, there are more property tax evaders among the rich.
2. There is no reason to pay as property tax collections are not properly spent.
3. Taxpayers who have strong political backing can evade payment easily.

A paradoxical observation is the direct relationship between the perception of the probability of detection and property tax delinquency. It appears that among landowners of commercial and industrial lands, delinquency is more probable if they expect to be caught. This finding is contrary to expectations. The attitude of the respondents towards the equity of the tax system can be used to resolve the paradox. Since the taxpayers feel that influential tax evaders enjoy the protection of certain local officials, they are confident that they can enjoy the same protection if and when they are caught. This confidence dispels the fear of penal consequences should they be caught. The fact that Obando (and a large majority of the localities throughout the Philippines) have failed to prosecute tax evaders bolsters this confidence. Among landowners of commercial properties, being caught does not matter as they can get away with it. It is likely that their financial capability to pay the penalties for property tax

3. Rate of exchange US$1 = ₱8.50.

delinquency lessens their fear of being detected. When they are asked, in fact, of their attitudes towards the fine for delinquency, the majority of them considered it light. Under the law, delinquency is fined at 2% of the tax for every month of delinquency but the maximum penalty that can be imposed is 24% of the delinquent tax. It will thus be advantageous for the taxpayer to cumulate his tax payments instead of paying his delinquency after a year. After all, the penalty is the same whether he is delinquent for one year or for 10 years.

Among employed residential land owners, the variable which is linked with delinquency is the perception of the inequity in the property tax system. However, the t-statistic of the coefficient (–1.7369) did not reach the .05 level which is conventionally acceptable. Using the 10% level of acceptability, it can be inferred that taxpayers are more probable to be delinquent if they have the view that the property tax system is inequitable.

Among the unemployed residential landowners, a pattern of relationship was also evident between the level of education and delinquency and the perception of the probability of detection and delinquency although the t-statistic is too low for any confidence to be placed in this finding.

Variable	Coefficient	t-statistic
Education	.7494	1.158
Perception	.2572	– 1.024

Delinquency moves directly with education and inversely with the probability of detection index. This implies that among unemployed residential landowners, delinquency is associated with those who have had more schooling and who think that evasion is difficult to detect. These inferences cannot be used as generalizations because of the lack of statistical significance of the coefficient of the noted observations.

The variable which tends to influence delinquency among employed owners of agricultural land is education. The level of education of taxpayers was found to be inversely related to delinquency. Like owners of commercial properties, landowners of agricultural lands tend to be delinquent if they have not attained a high level of education.

No variable in the model appears to influence delinquency among the unemployed. To account for the cause of their delinquency one can only fall back on a qualitative analysis of the reasons given by the respondents themselves. As cited earlier, most of them pointed to their poverty as the main reason for delinquency. This is quite credible as most of them realize that payment of taxes is important. When asked to identify the 3 most important reasons why they have to pay taxes, the following were cited:

1. It is the duty of every citizen to pay taxes.
2. Taxes finance the expenditures of the government.
3. It is an honor to pay taxes.

Only the minority (4% of the respondents) related payment of taxes to fear of the government and the lack of alternative except to pay taxes.

From the interviews with respondents, it can also be observed that lack of knowledge on property taxation could be one of the contributory causes of delinquency. Both the employed and unemployed respondents showed little knowledge of the importance of the property tax. When asked, for example, which level of government spends the proceeds from the property tax, 46% admitted they did not know; 33% said that the tax accrued to the national government and only 21% knew that the tax goes to the coffers of local government. Likewise, 36% of the respondents did not know the basis of the property tax. Some said the income of the taxpayer is the tax base (7%); others thought that the tax was based on the location of the land (11%) and others flatly admitted that they did not know the tax base (14%).

Another factor which may predispose taxpayers to evasion is disagreement with the property valuation. Over half the respondents disagreed with the assessor's valuation. Disagreement came mostly from owners of residential buildings (67%) who claimed that they do not know how the buildings they owned were valued. They were puzzled that despite the age of the buildings the valuation had not gone down significantly. This confusion is caused, among other things, by the failure to understand that buildings are valued through the replacement cost approach. This misunderstanding, which is caused by the taxpayers' lack of familiarity with the property tax system, should be an area of concern in Obando and possibly in other municipalities.

The final cause of delinquency in property tax payment is defective tax administration machinery. To date, the municipality of Obando has not actively used the following remedies provided by the law to collect delinquent taxes:

- distraint of personal property, including the crops on the land of the delinquent taxpayers;
- sale of delinquent real property tax at public auction;
- collection of the real property tax through the courts.

The non-use of legal remedies is not peculiar to Obando alone as only 3 out of 10 local units in the Philippines make use of the above powers (NTRC, 1980). When asked to account for the reasons behind the failure to enforce the penal provisions of the tax laws, the treasurers cited their preference for less strong measures, such as sending letters notifying the taxpayers of their delinquent accounts. This reaction is hardly surprising. The treasurer needs not only courage but also the full support of the executive and legislative branches of the local government to enforce collection of taxes on delinquent properties. In many instances, these may be lacking.

Summary and recommendations

The findings of this study suggest that evasion of the property tax is not a simple problem. In analyzing the causes of delinquency of all the sample taxpayers, no variable stood out as clearly significant. It was only when the analysis was carried out by land use that the study was able to relate delinquency to certain independent variables as follows:

- For owners of commercial and industrial real properties, delinquency is inversely related to education, tax ethics and the perception of equity. On the other hand, delinquency is directly related to the perception of the probability of detection.
- Among employed residential landowners, delinquency is more probable among those who think that the property tax system is inequitable.
- With employed owners of agricultural lands, delinquency is linked to a low level of education.

This changing list of factors influencing delinquency of taxpayers is quite complicated and the solutions suggested below must be qualified in certain instances. However, there are improvements in the tax administration machinery which can be generally prescribed.

Considering legal remedies first, the findings suggest that all delinquent taxes cannot be collected merely by threatening the taxpayers with civil action in court or by distraint of their personal property. A substantial number of delinquent taxpayers (40%) is employed and 64% have incomes less than ₱1,000. Bringing them to court would only create more problems for the local government. It seems clear that the enforcement of legal remedies can only be successfully applied to property with high assessed values (in this particular study, this pertains to those with assessed values above ₱5,000), especially properties which are commercial and industrial in nature. In this connection, increased vigor in the enforcement of legal remedies is called for. There is a general belief among delinquent taxpayers that the property tax system is quite inequitous. Moreover, delinquency among industrial landowners is associated with a certainty of being detected. Yet, because detection and punishment do not go together, the same taxpayers have the courage to evade the tax. They have to be convinced that the government is determined in future to collect all the taxes due. To encourage this spirit, granting a tax amnesty on delinquent property taxes is worth considering to give all property owners the chance to "make amends". As a basis for the proposed tax amnesty scheme, the government can draw the guidelines from the successful tax amnesty program on untaxed wealth and income which was implemented in 1972. After providing taxpayers with the chance to start with a clean slate, the local government can start the prosecution of evaders who have refused to cooperate.

It is also timely for the government to consider the revision of fines for delinquency. As discussed earlier, the limitation on the maximum amount of penalty to 24% of the delinquency encourages taxpayers to cumulate their delinquent accounts instead of pressuring them to pay after one year. This limitation should be lifted by allowing a 2% monthly surcharge on the amount of delinquency.

With respect to the delinquency of landowners owning residential lands, the national government should study the feasibility of granting an exemption to landowners who are incapable of payment. Although the basis of the tax is the assessed value of the property, the government should look into the possibility of using the income of the taxpayers as the basis of the exemption as residential properties on their own do not produce any income. To simplify administration, residential landowners who are exempt from payment of the income tax can also be exempt from payment of rates.

The second area which requires attention after the enforcement of legal remedies is the familiarization of taxpayers with the property tax system and its importance to local governments. Findings here suggest that the taxpayers do not know that the local governments depend heavily on the property tax to finance publicly provided goods and services. This lack of appreciation breeds indifference to payment of the tax. This is further aggravated by the failure to understand the nature of the property tax, its base and the method of its assessment. An information campaign should be launched by the municipality and two of its most effective media are the barangay officials and the teachers in the public schools. Orientation meetings on this tax with the two groups in attendance should be organized.

An increased familiarization of the taxpayers with the functions of their own local government is also favourable to the improvement of their tax ethics or their attitude towards tax compliance. Survey findings indicate a fairly low level of tax ethics. Although taxpayers feel that they have a duty to pay taxes to the national government, they cannot relate the same duty to the local government. This may be due to the lack of awareness of projects which are funded by the local government. It is surprising that residents in a particular locality like Obando are more informed of the activities and problems of the national government than those of their own local government. A publicity program, to improve this lack of communication must be designed by the municipality.

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Overseas Indians and the Finance Bill 1982

by Parimal M. Parikh*

Mr. Pranab Mukherjee, the Finance Minister of India, while introducing the Budget in the Parliament on 27 February 1982, anmnounced certain fresh incentives for Indians abroad who invest in India, which will go down as a major policy decision in the economic history of India.

It is therefore possible to strengthen the economic base of the country by augmenting foreign exchange resources and embarking upon industrial ventures where technical skills and the experience of operating in international markets are required.

More than 6 million people of Indian origin have settled abroad and their number is steadily increasing. Indians abroad, with their skill, ability and sheer hard work, have consolidated their economic position. Their cultural and economic links with India are intact. Some economists have estimated the wealth of persons of Indian origin residing abroad to be of the order of Rs. 115,000 crores (1 crore = 10,000,000), i.e. more than three fourths of India's annual gross national product.

In one way or another, they have always passed on part of their prosperity to the motherland. However, it is the feeling of many Indians abroad that the attitude of the government towards them has generally been lukewarm.

Some very important provisions with far-reaching consequences have been introduced in the Finance Bill 1982 in response to a long standing desire of Indians abroad.

An attempt is made hereunder to analyse and understand the proposed provisions and their implications.

I. DEFINITION OF "RESIDENCE"

In India the scope of total income of an assessee is determined on the basis of residential status. For this purpose assessees are divided into the following two categories:

- resident; and
- non-resident.

The individual "resident" in India is further classified as:

- ordinarily resident; and
- not ordinarily resident.

A person who is *ordinarily resident* is liable to tax on all income:

(a) which is received or is deemed to be received in India by or on behalf of such person;
(b) which accrues or arises or is deemed to accrue or arise to him in India; and
(c) which accrues or arises to him outside India.

A person who is *not ordinarily resident* is liable to tax in the same manner as a person who is "ordinarily resident", *except* that the income which accrues or arises to him *outside* India is not includible in his other income unless it is derived from a business controlled in or a profession set up in India.

A person who is a *non-resident* is liable to tax in respect of all income from whatever source derived which is received or deemed to be received in India by or on behalf of such person or which accrues or arises or is deemed to accrue or arise to him in India. He is *not liable* in respect of income accruing or arising *outside India* even if it is remitted to India.

Thus, the liability to pay income tax in India is dependent on the residential status of an assessee.

Under the existing provisions (Section 6 of the Income-tax Act (ITA), 1961) an individual is considered to be "resident" in India in any year if:

(a) he is in India in that year for a period or periods amounting in all to 182 days or more; or
(b) he maintains or causes to be maintained for him a dwelling place in India for a period or periods amounting in all to 182 days or more in that year *and* has been in India for 30 days or more in that year; or
(c) having within the 4 years preceding that year been in India for a period or periods amounting in all to 365 days or more, is in India for a period or periods amounting in all to 60 days or more in that year.

The Finance Act 1978, with effect from 1 April 1979, inserted an Explanation to Section 6(1) to secure that in the case of an Indian citizen rendering services outside India, and who is or has been in India on leave or vacation in the previous year, the 30 and 60-day periods respectively referred to in (b) and (c) above are extended to 90 days. The effect of this provision is that an Indian citizen *employed* outside India is able to stay on leave or vacation in India for 89 days in a previous year without becoming resident in India in that year.

With a view to avoiding hardship in the case of Indian citizens who are employed or engaged in other vocations outside India, the Finance Bill 1982 seeks to make certain modifications in the tests of "residence" in India.

One of the conditions for being treated as a "resident" is dependent upon maintenance of a dwelling place for more than 182 days *and* stay in India in a given year for 30 days or more. This condition was causing hardship to In-

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dians going abroad in the middle of a year to take up employment outside India inasmuch as they were being treated as "residents" in the year of their departure, with the consequence that their income *outside* India also suffered Indian taxation. As we have seen above, under the Income-tax Law, "residents" have to pay tax in India on their total *world* income, while "non-residents" pay tax only on their *Indian* income. This condition of dwelling place is being removed with effect from 1 April 1983, that is, the assessment year 1983-84.

Yet another condition causing hardship was in relation to a person in India for 60 days or more in a year and who was in India for 365 days or more in the preceding 4 years. For such persons also, a stay up to 182 days in a year does not make them "residents" with the resultant taxation in India of their foreign income. No doubt this benefit of 182 days is available only for the first year of their departure for the purpose of taking up *employment* outside India. A further amendment appears to indicate that the benefit of stay up to 182 days is not available to persons not taking up employment but becoming *self-employed* or otherwise. Self-employed persons will be governed by the test of stay of 90 days or more, as provided in the explanation to Section 6(1) of the Income-tax Act, 1961.

II. REMITTANCE OF FUNDS TO INDIA

The next amendment is to be found is Section 10 of the Income-tax Act, 1961, first in respect of Section 10(4A) which exempts from tax income from interest on moneys standing to the credit of a "non-resident" in a non-resident (external) account in any bank in India in accordance with the Foreign Exchange Regulation Act, 1973 (FERA).

According to FERA, Indian nationals and persons of India origin holding foreign passports residing abroad can freely remit funds to India through banking channels and keep them in their accounts with banks authorised to deal in foreign exchange ("authorised dealers"). The following facilities are available for these persons for remittance of funds to India and for making investments in India.

1. Non-resident (external) accounts designated in Indian rupees (NR(E) accounts)

The funds must be transferred to India through banking channels from the country of residence or from any other country in the External Account group other than Bulgaria, Czechoslovakia, German Democratic Republic, Hungary North Korea, Poland, Romania and the U.S.S.R. The facility is also available to government servants posted abroad on duty with Indian Missions and similar agencies set up abroad by the Government of India where the officials draw their salaries out of Central Government resources, Government servants deputed abroad on assignments with foreign government or regional/international agencies like the World Bank, IMF, WHO, ESCAP, and officials of a State Government and public sector undertakings deputed abroad on temporary assignments or posted to branches of their offices abroad.

The advantages of opening the above type of account are:

- The income accruing on the balances in the accounts is free of Indian income tax (Section 10 (4A) of ITA).
- The account holders have the freedom to repatriate the balances, along with the interest accrued thereon, outside India at any time without reference to the Reserve Bank of India.
- Interest accruing on the accounts may be credited to the accounts freely by authorised dealers.
- Debits to the accounts for local disbursements are freely permissible.
- Purchase of units of the Unit Trust of India, Government securities and National Plan Certificates or National Savings Certificates from the balances in these accounts may be made freely.
- Dividends or interest on and sale or maturity proceeds or repurchase price of the units, securities or certificates may be credited to the external accounts, on application to the Reserve Bank of India.

2. Non-resident (external) accounts designated in foreign currencies (FCNR accounts)

In order to provide account holders a cover against the risk of any loss arising from fluctuations in the exchange rate of currencies, a new scheme for opening non-resident (external) accounts designated in special foreign currencies (pounds sterling and U.S. dollars) has been introduced. The accounts are maintained in the currencies in which the remittances are received and the funds are also to be repaid to the account holder, or transferred elsewhere in India under his instructions, in the same currency. The interest is paid in the currency in which the account is maintained. This interest is also free of Indian income tax (Section 10 (4A) of ITA).

Thus, the exchange risk in respect of both the funds remitted to India by the account holders and the interest accruing on the funds is not to be borne by the non-resident depositors. To start with, the accounts are maintained in the form of fixed deposits for periods of 91 days and above, but not exceeding 61 months at a time. This period of 61 months can be further extended.

The present condition for exemption under Section 10 of ITA is that the person should be a "non-resident" under ITA. The tests for being treated as "non-resident" under FERA and under ITA are entirely different. The amendment seeks to exempt such income of "non-residents" under FERA.

To determine the residential status of a person under FERA, the following questions must be answered:

- Is he an Indian citizen or not?
- If he is an Indian citizen, has he been staying in or outside India and for what purpose?
- If he or she is a foreigner staying in India, what is the purpose of his or her stay, whether his or her wife or husband is a person resident in India, and what is the duration of his or her stay here?

Section 2(p) of FERA lays down specific norms for determining the residential status of person as follows:

(a) If an Indian citizen has been staying in India at any time after 25 March 1947, he is regarded as a person resident in India.

(b) If an Indian citizen has gone out of India:
    (i) for employment, business, or vocation outside India; or
    (ii) for any other purpose with the intention of staying outside India for an indefinite period,

he is regarded as a person not resident in India.

Even though the word "profession" is not mentioned in Section 2(p), if an Indian citizen leaves India to carry on his profession outside India, he will become a person resident outside India.

If an Indian citizen has gone abroad for his studies, a pleasure trip, medical treatment, a business trip, visiting friends or relatives, and other purposes where the intention is not to stay abroad for an indefinite period, he will be regarded as a person resident in India during his stay abroad.

(c) An Indian citizen who was abroad and was regarded as a person resident outside India under the preceding provisions will be regarded as a person resident in India when he returns to India for employment, business, or vocation in India. Similarly, if he returns to India for any other purpose with an intention to stay in India for an indefinite period, he will be regarded as a person resident in India.

(d) An Indian citizen who has not stayed in India at any time after 25 March 1947 coming to India for employment, business, or vocation, staying with his or her spouse who is resident in India, or for any other purpose, with an intention to stay for an indefinite period, will be regarded as a person resident in India.

(e) A foreign citizen who has come to stay in India for employment, business or vocation in India will be regarded as a person resident in India. Similarly, if a foreign citizen stays in India with his or her wife or husband who is resident in India, the foreigner will be regarded as a person resident in India during his or her stay in India even if the stay of the foreigner is temporary.

If a foreigner stays in India for any other purpose and his stay is for an indefinite period he will be regarded as a person resident in India. If, however, a foreign citizen has become a person resident in India for the reasons stated in the preceding paragraph, he will become a non-resident during the period he is outside India even though that period is of short duration.

For example, if an Indian after becoming a British citizen comes to India for employment, business or vocation in India, he will be regarded as a person resident in India. But during his temporary stay abroad, his status will change and he will be treated as a non-resident.

(f) The residential status of a person does not depend upon that of his or her husband, wife or parents. For example, if a married Indian citizen has gone abroad for employment, he will become a non-resident. If his spouse, who is otherwise treated as a person resident in India, goes abroad to stay with him for a temporary period, she will continue to be a person resident in India.

Thus it may be observed that the definitions of "resident" and "non-resident" are totally different under FERA and ITA.

It is possible that a person may be *non-resident* under FERA but *resident* under ITA. Such a person would be denied this exemption.

With a view to removing this anomaly it is proposed to provide that the exemption from income tax in respect of interest on non-resident (external) accounts shall be available in the case of a "person resident outside India" as defined in Section 2(q) of FERA.

Similarly, the balance standing to the credit of such non-resident (external) accounts is exempt under Section 6(ii) of the Wealth Tax Act, 1957.

The Finance Bill 1982 also seeks to exempt gifts made by non-resident Indian citizens and foreign nationals of Indian origin out of the moneys to their credit in non-resident (external) accounts in India.

However, balances held in non-resident (external) accounts are not exempt from Estate Duty (i.e. death duty).

A recent announcement made by the Reserve Bank of India (RBI) permits overseas companies, firms, societies and trusts to invest freely in units of the Unit Trust of India, securities (other than bearer securities) of Central and State Governments and national savings certificates from the funds held in their NR(E) accounts and FCNR accounts or by sending remittances directly from abroad. Such investments enjoy the benefits of repatriation of capital as well as income earned.

Overseas companies, partnership firms, societies and other corporate bodies which are owned to the extent of at least 60% by Indian nationals or persons of Indian origin residing abroad, as well as overseas trusts in which at least 60% of the beneficial interest is irrevocably held by such persons, can now open with any bank authorised to deal in foreign exchange in India NR(E) Rupee Accounts and FCNR Accounts in U.S. dollars or pound sterling out of the funds transferred by them to India. Hitherto, only Indian nationals and persons of Indian origin residing abroad were given this facility. All authorised dealers have been permitted to freely open such accounts out of the funds received from any country in the External Account Group other than Bulgaria, Czechoslovakia, German Democratic Republic, Hungary, North Korea, Poland, Romania and the U.S.S.R.

To open such accounts, the concerned party will, however, have to produce to authorised dealers a certificate from an overseas auditor, chartered accountant, or certified public accountant in a precribed form to the effect that the ownership/beneficial interest in these entities is held to the extent of at least 60% by Indian nationals or persons of Indian origin residing abroad.

III. NATIONAL SAVINGS CERTIFICATES

With a view to encouraging the remittance of foreign exchange into the country, a new sub-section (4B) is proposed to be inserted with effect from 1 April 1983, that is, from assessment year 1983-84, to provide an exemption from income-tax for interest in 12% 6-year National Savings Certificates to be issued hereafter by the Central Government. The exemption will be available to *"non-resident" Indians* or to foreign nationals of *Indian origin* provided that the subscription to the certificates is in *foreign currency* in accordance with the provisions of FERA. Thus, this exemption shall be available only to initial subscribers of these 6% National Savings Certificates.

A corresponding exemption from wealth tax is also provided by Section 5(1) (xvi c) of the Wealth Tax Act, 1957 whereby non-resident Indian citizens and foreign nationals of Indian origin can avail themselves of this exemption provided that the subscription to the certificate is in foreign currency in accordance with the provisions of FERA.

Similarly, Section 5(1) (ii d) of the Gift Tax Act, 1958 seeks to grant exemption from gift tax to gifts of such Savings Certificates by non-residents to their *relatives* who are "residents" in India. For this purpose, "relative" is defined by Section 2(21) of the Income Tax Act, 1961 as including husband, wife, brother, sister or any lineal ascendant or descendant of that individual.

IV. INVESTMENT IN SHARES

The recent announcement made by the RBI liberalises the policy governing investment in Indian companies by Indian nationals or persons of Indian origin residing abroad.

RBI has also simplified the procedural formalities in this regard to facilitate a higher inflow of non-resident investment. According to an RBI notification, the facilities are available to all Indian nationals or persons of Indian origin residing abroad.

The facilities extended include permission to invest in shares without any limit on the quantum or value of the investment, permission to make portfolio investments in shares with full benefits of repatriation of capital invested and income earned, and expeditious sale and transfer of shares by such persons.

Under the liberalised facilities, such persons can invest in shares through stock exchanges in India without any limit on the quantum and value of investment, either by fresh remittances from abroad or out of their NR(E), or FCNR or Non-resident Ordinary accounts. Repatriation of capital invested and income earned thereon will not, however, be allowed.

In order to avoid references, for specific approval of each transaction, the RBI will grant permission to banks in India authorised to deal in foreign exchange for purchasing and selling shares on behalf of their clients.

They can also invest in new issues of public or private companies engaged in any business activity (except real estate business) up to 100% of the issued capital without any obligation to associate resident Indian participation in equity capital at any time.

They can also make portfolio investments in shares in India with full benefit of repatriation of capital invested and income earned thereon, provided:
- the shares are purchased through a stock exchange;
- the purchase of shares in any one company does not exceed 100,000 Rupees in face value or 1% of the paid-up equity capital of the company, whichever is lower; and
- payment for such investment is made either by fresh remittances from abroad or out of the funds held in the NR(E) or FCNR account with a bank in India.

As in the case of investment in shares without repatriation benefits, the RBI will grant permission to banks to purchase shares through stock exchanges on behalf of their non-resident customers, subject to the limit and conditions mentioned above.

They can make investment in the new issues of new or existing companies in India (other than a FERA company) up to 40% of total new capital with full benefits of repatriation of capital invested and income accruing thereon. They can also make investment with full repatriation benefits in the capital raised by any company other than through issue of prospectus up to 40% of total new capital subject to a ceiling of 4 million Rupees. Such investments can be made in any industry including those in the "negative" list of industries (which has been withdrawn), as well as in the hotel industry.

If subscriptions or portions thereof are refunded by companies, banks may allow the amounts to be re-credited to the applicants' accounts from which they had been withdrawn earlier. Similarly, where subscriptions to new issues were remitted from abroad by such persons to companies in India or to bankers to the issues, banks may remit the refunds of excess subscriptions to the concerned beneficiaries.

The facility of equity investment with full repatriation benefit under the 74% scheme continues, with a further relaxation that the investment can now also be made in the hotel industry, apart from the priority industries.

To facilitate the expeditious sale and transfer of shares by such persons through stock exchanges, a consolidated application furnishing full particulars of their holdings in quoted shares may be made to the RBI. The bank will grant permission for the sale of these holdings, initially with a one-year validity period, renewable for further periods subsequently. These shares can then be sold at any time within the validity period.

Such person can freely invest in Six-year National Savings Certificates. Such investments will be free from wealth tax, income-tax and gift tax and they enjoy the same facilities as are available for repatriation of maturity proceeds of other Government securities or credit thereof to non-resident accounts of the beneficiary.

All the facilities of direct and portfolio investments outlined above have been extended to overseas companies partnership firms, societies and other corporate bodies, which are owned to the extent of at least 60% by Indian nationals or persons of Indian origin residing abroad as well as overseas trusts in which at least 60% of the beneficial interest is irrevocably held by such persons.

V. EXEMPT GIFTS

Section 5(1) (ii c) of the Gift Tax Act 1958 seeks to grant exemption from gift tax of gifts to *relatives* of any amount of foreign currency or other foreign exchange remitted from a country outside India by *non-resident Indians* or foreign nationals of *Indian origin*.

THE 1982 INCOME TAX CHANGES IN THE REPUBLIC OF SOUTH AFRICA

by Dr. Erwin Spiro

Presenting the 1982 Budget on the 24th March, 1982, the Minister of Finance, Prof. Owen Horwood, confessed to aspiring to comply with three minimum requirements: first, to restrict the increase in government spending as much as possible without disrupting the provision of essential services; second, in order to assist in curbing monetary demand and to prevent undue upward pressure on interest rates, to reduce the 'deficit before borrowing' as a percentage of gross domestic product to well below its average of 3.4% over the past 22 years and, third, to finance this deficit in such a manner that not only the Exchequer, but also the government sector as a whole, including the extra-budgetary funds, were able to avoid a net recourse to bank credit. It is against this background that the following income tax changes must be understood.

I. STRUCTURAL INCOME TAX REFORMS

Fringe benefits

The recommendations of the Parliamentary Commission in respect of fringe benefits arising from employment or from the holding of an office will, upon receipt, be considered by the government without delay and, if found to be acceptable, be notified to employer and employee organizations in good time so that any legislation which may be required can be introduced early in the next year in order to ensure that the recommendations take effect as from 1 March 1983 (that is for the 1983/1984 tax year).

Final PAYE deduction system

As announced in the 1981 Budget speech, persons whose taxable incomes (that is net salary (wage) after deduction of medical expenses, pension and retirement annuity fund contributions and the allowance of the earnings of a spouse), do not exceed R7,000, will, with effect from 1 March 1982, no longer be required to submit annual returns of income. In the present budget the Minister of Finance made it quite clear that the new measure would not be applicable to persons who received substantial investment income not taxed at source or to those whose income was received in a form other than fixed salaries, wages or pensions.

II. ONGOING TAX REFORMS

Exemptions

The first R100 of the aggregate income derived from interest and dividends will be exempt from tax, such exemption being granted to all taxpayers irrespective of their income.

Rebates

The primary rebates have been increased by R120.

Deductions

Married women. It has still not been possible to formulate a preferable alternative to the present system whereby the incomes of married persons are aggregated for taxation urposes. However, the deduction allowed from the earnings of a married woman is increased from the R1,200 applicable in the 1980/1981 tax year to R1,400 in the 1981/1982 tax year and to R1,600 in the 1982/1983 tax year.

Housing. Investors who plan to erect housing accommodation for rent will be granted the annual depreciation allowance of 2% at present applicable to new industrial buildings. This will apply to all new housing projects which offer not less than five family housing units for rent, provided the erection commences on or after 1 April 1982:

In addition an initial allowance of 10% of the cost of the project will be allowed as a deduction from income in the year in which the project is completed and the accommodation is first let to tenants.

If the developer of the housing project should dispose of such property either by means of an outright sale of the whole project or through sectional little selling of individual units, or in any other way, the allowances previously granted will be recouped and included in his taxable income.

Taxable income of long-term insurance companies

In view of the enormous growth of the long-term insurance industry, the percentage of gross investment income used as a yardstick for measuring taxable income is to be increased from 30 to 40%.

Loan levy on individuals

A 5% loan levy will be imposed on income tax payable by individuals, the following taxpayers being exempted therefrom:

(a) persons of all age groups whose incomes are R7,000 or less. Falling as they do, at least most of them, under the Final PAYE Deduction System (supra), they will be taxed at a fixed rate, and it would not be fair to impose upon them the further loan levy.

(b) other persons, whose basic normal income tax before the addition of loan levy amounts to R150 or less;

(c) persons who are 70 years of age and older and whose taxable incomes exceed R7,000, but do not exceed R15,000 per annum (they, of course remain liable for normal tax).

The levy is a compulsory loan, repayable within a maximum period of 7 years at simple tax-free interest, its rate being raised from 5 to 8%.

Company tax

Ordinary companies. The present 5% surcharge is to be incorporated in the basic rate, thus becoming 42%, and a further surcharge of 10% is to be levied on such new basic rate.

This applies to all companies excluding gold and diamond mining companies.

Gold and diamond mining companies. The basic rate is not increased. But the present surcharge of 5% is increased to 15%. That change serves the purpose, inter alia, to meet the increased demands which will be made on the Exchequer in the form of assistance to the marginal gold mines.

III. RATES OF (NORMAL) INCOME TAX

Persons other than companies

Persons other than companies are, in respect of the taxable income derived in the year of assessment ending 28 February 1983 or 30 June 1983, whichever is applicable, subject to (normal) income tax at the rates contained in the TABLE attached, with a maximum basic marginal rate of 50% and with the addition, in the case of unmarried persons, of a 20% surcharge on the tax. The maximum rate is reached where the taxable income exceeds R40,000 in the case of married persons and R28,000 in the case of unmarried persons.

If the taxable income is greater than R7,000 and the tax is not less than R150, the loan levy of 5%, mentioned above, must be added to such tax.

Companies

Companies are, in respect of taxable income derived in respect of every year of assessment ending during the period of twelve months ending on 31 March 1983, subject to the following rates of (normal) income tax:

(i) on each R of the taxable income (excluding taxable income derived from mining operation and taxable income referred to in (ii)(c)) 42 cents plus a surcharge equal to 10% of the tax;

(ii) in respect of taxable income derived from gold mining:

(a) in the case of any mine other than a post-1966 gold mine an amount determined in accordance

INCOME TAX TABLE REFERRED TO IN III. ABOVE
for persons other than companies

Taxable income	Rates of tax
Where the taxable income –	
does not exceed R7,000	10% of each R1 of the taxable income;
exceeds R 7,000 but does not exceed R 8,000	R 700 plus 12% of the amount by which the taxable income exceeds R 7,000
exceeds R 8,000 but does not exceed R 9,000	R 820 plus 14% of the amount by which the taxable income exceeds R 8,000;
exceeds R 9,000 but does not exceed R10,000	R 960 plus 16% of the amount by which the taxable income exceeds R 9,000;
exceeds R10,000 but does not exceed R11,000	R 1,120 plus 18% of the amount by which the taxable income exceeds R10,000;
exceeds R11,000 but does not exceed R12,000	R 1,300 plus 20% of the amount by which the taxable income exceeds R11,000;
exceeds R12,000 but does not exceed R13,000	R 1,500 plus 22% of the amount by which the taxable income exceeds R12,000;
exceeds R13,000 but does not exceed R14,000	R 1,720 plus 24% of the amount by which the taxable income exceeds R13,000;
exceeds R14,000 but does not exceed R15,000	R 1,960 plus 26% of the amount by which the taxable income exceeds R14,000;
exceeds R15,000 but does not exceed R16,000	R 2,220 plus 28% of the amount by which the taxable income exceeds R15,000;
exceeds R16,000 but does not exceed R18,000	R 2,500 plus 30% of the amount by which the taxable income exceeds R16,000;
exceeds R18,000 but does not exceed R20,000	R 3,100 plus 32% of the amount by which the taxable income exceeds R18,000;
exceeds R20,000 but does not exceed R22,000	R 3,740 plus 34% of the amount by which the taxable income exceeds R20,000;
exceeds R22,000 but does not exceed R24,000	R 4,420 plus 36% of the amount by which the taxable income exceeds R22,000;
exceeds R24,000 but does not exceed R26,000	R 5,140 plus 38% of the amount by which the taxable income exceeds R24,000;
exceeds R26,000 but does not exceed R28,000	R 5,900 plus 40% of the amount by which the taxable income exceeds R26,000;
exceeds R28,000 but does not exceed R30,000	R 6,700 plus 42% of the amount by which the taxable income exceeds R28,000;
exceeds R30,000 but does not exceed R32,000	R 7,540 plus 44% of the amount by which the taxable income exceeds R30,000;
exceeds R32,000 but does not exceed R34,000	R 8,420 plus 46% of the amount by which the taxable income exceeds R32,000;
exceeds R34,000 but does not exceed R36,000	R 9,340 plus 47% of the amount by which the taxable income exceeds R34,000;
exceeds R36,000 but does not exceed R38,000	R10,280 plus 48% of the amount by which the taxable income exceeds R36,000;
exceeds R38,000 but does not exceed R40,000	R11,240 plus 49% of the amount by which the taxable income exceeds R38,000;
exceeds R40,000	R12,220 plus 50% of the amount by which the taxable income exceeds R40,000.

with one of the formulae laid down plus a surcharge which is not payable in respect of certain assisted gold mines equal to 15% of the said amount;

(b) in the case of post-1966 gold mines an amount determined in accordance with one of the formulae laid down plus a surcharge of 15% 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) in the case of companies mining for diamonds 45 cents per R1 of the taxable income plus a surcharge of 15% of such amount;

(iv) in the case of companies mining, but not for gold or diamonds, the position is the same as in the case of a non-mining company (see (i) above).

Taxpayers carrying on long-term insurance business

The taxable income derived from the carrying on of long-term insurance business by any taxpayer who carries on such business in the Republic (whether on mutual principles or otherwise) is deemed to be an amount equivalent to 40% of the gross income derived from investments.

IV. RATES OF OTHER TAXES CONTAINED IN THE INCOME TAX ACT

Non-resident shareholders' tax

The non-resident shareholders' tax is 15% of the amount of the dividend or interim dividend in question.

Undistributed profits tax

The undistributed profits tax is 33⅓ 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% 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%.

SOUTH AFRICA:

Budget 1982

Extracts from the Budget Speech pronounced by Professor Owen Horwood, Minister of Finance, on 24 March 1982.

World economic recession

This year's Budget is being presented against the background of a serious and long-lasting world recession. In the United States the rate of real economic growth was actually negative in 1980, less than 2% in 1981 and, according to the latest forecasts of the Organization for Economic Co-operation and Development, will be negative again in 1982. In the United Kingdom, the real economic growth rate was minus 1.7% in 1980, minus 2% in 1981 and is now expected to recover to a small positive figure in 1982. In West Germany a growth rate of minus 1% in 1981 is expected to be transformed into a positive rate of just over 1% in 1982. In addition, the countries behind the Iron Curtain and a number of important oil-producing states have been experiencing serious economic difficulties, which have forced some of them to sell large quantities of gold on world markets. At the same time, the economic plight of most Third World countries has reached critical proportions.

Revenue 1982-'83

Estimated total revenue on the current basis of taxation amounts to R15 417 million, which is 7.9% higher than the revised 1981-'82 estimate of R14 290 million. Receipts both from Inland Revenue and from Customs and Excise are expected to increase – Inland Revenue by R912 milion and Customs and Excise by R215 million. These estimates already include the increased proceeds to be collected from the one percentage point increase in general sales tax and the 10% import surcharge announced last month.

The additional revenue from these two sources, now estimated to amount to about R1 235 million, will in itself only partly offset the decrease in the collections from income tax on gold mines and gold mining leases. Estimated receipts from the gold mining industry during 1982-'83 most probably will amount to no more than R900 million, compared with R2 171 million in 1981-'82 – a reduction of nearly R1 300 million in one year. This huge loss in revenue is the direct result of the adverse effect that the drop in the gold price and cost escalations are expected to have on the operating results of the gold mines.

Uncertainty regarding the future behaviour of the gold price makes it extremely difficult, if not virtually impossible, to predict with any degree of accuracy Exchequer revenues from this source. While I am certainly not pessimistic on the longer term outlook for gold – anything but – it would only be prudent to assume that the average gold price for the year 1982-'83 will be significantly below the average realized during the current financial year, and I have framed my estimates accordingly.

To sum up, on the current basis of taxation, total tax revenues of R15 417 million are available to finance total expenditures of R18 238 million. The deficit before borrowing at his stage thus amounts to R2 821 million.

Despite the financing problems we are faced with now, I wish to announce the following concessions.

Final PAYE deduction system

In my Budget speech last year I announced that, with effect from the tax year which commenced at the beginning of this month, persons in the lower income categories who derive their income entirely, or almost entirely, from salaries, wages or pensions, will no longer be required to submit annual returns of income. In the majority of such cases the PAYE, which will be deducted in terms of the new deduction tables which came into operation on the first of this month, will represent a final settlement of their tax liability. A substantive amendment was included in last year's Income Tax Act to make this possible.

Persons affected by this measure are those whose taxable incomes, that is, net salary after deduction of medical expenses, pension and retirement annuity fund contributions, and the allowance in respect of the earnings of a spouse, do not exceed R7 000.

The new measure cannot, of course, be applied to persons who receive substantial investment income not taxed at source, or to

...illion in 1975 to R0.9 million in 1980, no doubt mainly due to the advent of television.

The Standing Commission has recommended that the tax be abolished. I am in agreement with this recommendation and, in the interest of more efficient administration, accordingly propose that the tax be abolished with effect from 1 April 1982. The loss of revenue will amount to some R1 million.

The total of the concessions I have just outlined amount to R34 million and will reduce receipts from Inland Revenue from the printed figure of R13 198 million to R13 164 million.

Before turning to certain proposals for relief from excise duties, there are two further inland revenue matters to which I should like to refer.

Fringe benefits

The taxation of fringe benefits arising from employment or from the holding of an office, which has been part of our income tax law ever since its inception, has in principle been reaffirmed by the Government. The question in regard to the uniform valuation of such benefits is, however, one which should be approached very circumspectly.

Certain proposals were first put forward by the Franzsen Commission in 1970. The matter was subsequently investigated by Inland Revenue and the Standing Commission on Taxation Policy. After protracted and wide-ranging discussions, it was decided that the Standing Commission's valuation proposals should form the basis of an in-depth inquiry by a Parliamentary Commission.

Although reports have appeared in the Press to the effect that the proposals for the taxation of fringe benefits have been shelved, I wish to give the assurance that this is not the case. The recommendation of the Parliamentary Commission, will, upon receipt, be considered by Government without delay and, if found to be acceptable, will be notified to employer and employee organizations in good time so that any legislation which may be required can be introduced early in the next year in order to ensure that the recommendations take affect as from 1 March 1983, that is for the 1983-'84 tax year.

Fiscal incentive measures

In my Budget Speech on 26 March 1980 I indicated that I had directed the Standing Commission on Taxation Policy to investigate the initial and investment allowances accruing to manufacturers and to make recommendations to me in this regard. The matter is one of extreme complexity and, as I previously said, caution is needed before any change is made to the *status quo*. I am informed that the Standing Commission has made good progress in its task and am hopeful that it will be possible for the Commission to submit its recommendations to me within the next few months. It appears unlikely, however, that any consequential legislation will be introduced during the current session of Parliament.

I wish now to propose two concessions in regard to excise duties.

Excise duty concessions

Natural wines

The agricultural industry in the Western Cape is one of the main supports of the regional economy and provides an important impetus to development and growth. It is also true that agriculture in this region is much dependent upon the weal and woe of the products of the vine.

At the same time wine provides the State with not inconsiderable excise revenues and in this way assists in financing necessary expenditures. Yet it is also true that in the case of natural wines, notwithstanding a slight, albeit consistent upturn in demand, consumption *per capita* today is still below the 1975 level and this despite an annual average producers' price rise of less than 9% during this period.

I wish to propose, therefore, that the full excise duty of 3 cents per litre on natural wines be abolished. Though the incidence of this duty may be small, I am told the concession will bring South Africa into line with other wine-producing countries such as West Germany, Italy, Austria, Switzerland and Australia.

The loss of revenue is calculated to amount to R6 million in 1982-'83.

In the case of natural fermented apple, pear and orange beverages I propose that the excise duty be similarly withdrawn. The loss of revenue in this case will be minimal.

Natural fruit juices are, of course, not subject to any excise duty.

Non-alcoholic beverages

This industry has had to cope in recent times with substantial increases in input costs, one of the latest examples being an increase in the price of sugar of some 13%. Any tax concessions will grant a measure of relief not only to the producer and the consumer but will also, I understand, tend to be helpful to the small businessman in the rural areas. I wish to propose, therefore, that the excise duty on non-alcoholic beverages be reduced by 1 cent per litre. This will mean an estimated loss of revenue in 1982-'83 of some R10 million.

Government notices to give effect to these proposals will appear tomorrow.

The total cost of these two concessions will amount to R16 million and will reduce the income from customs and excise duties in the printed Estimates of Revenue to R2 203 million.

Financing of deficit

The estimate of total revenue is now R15 637 million, which leaves me with a deficit before borrowing of R2 871 million at this stage. After adding to the deficit an amount of R1 246 million to provide for loan redemptions and other loan expenditures – the latter figure is very substantially lower than total redemptions for the 1981-'82 financial year – the total financing requirement will amount to R4 117 million.

I propose that this amount be financed as follows:

	R million
Public Debt Commissioners	1 290
Reinvestment of maturing stock	614
New stock issues	800
Non-marketable securities	550
Foreign loans	250
Surplus carried forward from 1981-'82	16
	R3 520

This still leaves me with a shortfall of R597 million.

National Defence Bonds and Defence Bonus Bonds

I should explain that the non-marketable securities I have just mentioned comprise tax-free Treasury Bonds, tax-free Defence Bonus Bonds and taxable National Defence Bonds.

Recently in my Part Appropriation speech I announced an increase in the interest rate on Treasury Bonds and indicated that I would also deal with improvements in the terms of issue of National Defence Bonds and Defence Bonus Bonds in due course.

It has now been decided that the interest rate payable on fully taxable National Defence Bonds – which have a minimum currency of twelve months – be raised from 11% to 14% with effect from 1 April 1982 to make them more attractive in the market.

From the same date the method of calculating interest on the tax-free Defence Bonus Bonds will also be changed from the current 5% simple interest basis to a 5% monthly compounded basis, which will yield an effective 5.66% per annum over a five-year term. This compound rate of interest will also apply to all existing unredeemed investments made since the inception of the scheme provided that the Bonds are not redeemed before 1 April 1983. Interest on redemptions made before that date will continue to be calculated at the existing simple interest rate. These adjustments should at least ensure a positive flow of investment funds into these two investment media.

The loan programme set out above presupposes that funds be obtained in the domestic market in a non-inflationary manner at realistic market-related rates and care will therefore be taken to limit the individual stock issues to smaller amounts obtainable without undue difficulty and without placing undue pressures on the money and capital markets and thus on interest rates. Smaller stock issues will also ensure a more even distribution of cash flows to the Treasury throughout the year.

I also believe that the Exchequer should approach the markets for its loan requirements on a more regular basis than hitherto. The success of the Treasury's first tender issue has been most heartening considering the difficult conditions pertaining in the market at the time, and this method will again be used those whose income is received in a form other than fixed salaries, wages or pensions.

It is gratifying to note that even at the relatively low income levels, many persons are still able and willing to save, and in order to encourage savings and not to deprive them of the benefits of the new system, I furthermore propose that the first R100 of their aggregate income derived from interest and dividends be exempt from tax. This exemption will, in fairness, be granted to all taxpayers irrespective of their income, and I estimate the concomitant loss of revenue to the Fiscus for the 1982-'83 financial year at R13 million.

Although taxpayers in the category I have mentioned will not in future be required, as a matter of course, to submit returns of income for assessment purposes, I realize that factors, such as the birth of a child or abnormally high medical expenses may result in over-deductions of PAYE. In such cases, taxpayers will still be entitled to ask for an assessment and a refund of tax overpaid.

There is a point which I would like to stress in regard to the new system, and that is it does not affect the year of assessment which ended on 28 February this year. Income tax returns in respect of that year were recently mailed and must still be completed by all taxpayers. The Commissioner for Inland Revenue will in due course advise all those taxpayers who will not in future be required to complete returns of income.

The adjustments and simplifications which I have referred to will make the tax collection system that much more cost-effective and is a further positive step in our overall tax reform programme.

Primary rebate

It is apparent from the new normal tax rate table which will be tabled today, that the rate of tax applicable to the first R7 000 of an individual's taxable income is 10%. Previously the rate of tax for the first R6 000 was 8% and from R6 001 to R7 000 it was 10%. The proposed new rate results in an additional R120 gross tax payable, before the deduction of rebates. The increase in the rate is not intended to be an additional impost on taxpayers but has been decided upon as part of the scheme for the elimination of unnecessary income tax assessments in the case of salary earners whose taxable incomes do not exceed R7 000, as explained. To neutralize the increase in the gross rates, an additional rebate of R120 was provided for in last year's Income Tax Act as part of the scheme to put into operation the PAYE final deduction system as from 1 March 1982.

The sacrifice of revenue, which is confined to the R0 - R7 000 income sector, is estimated at R40 million and has also already been taken into account in the printed Estimates of Revenue.

The increase in the primary rebate, taken together with the standard deductions for medical and certain other expenses and the standard insurance rebate provided for in last year's Income Tax Act, will have the effect of raising the tax thresholds of individuals without children or dependants as follows:

	Present threshold	Proposed threshold
Married person		
– under 60	R2 500	3 800
– 60 but under 70	R4 000	R5 000
– 70 and over	R5 000	R5 800
Unmarried person		
– under 60	R1 500	R2 850
– 60 but under 70	R3 000	R4 050
– 70 and over	R4 000	R4 850

Married women

Honoré de Balzac once said that "women are always afraid of thing which have to be divided". This does not seem to be the case with the vexed question of the taxation of the income of married women, a matter which continues to enjoy the attention of the Department and the Standing Commission on Taxation Policy.

It has still not been possible to formulate a preferable alternative to the present system whereby the incomes of married persons are aggregated for taxation purposes. However, as I announced during my 1981-'82 Budget Speech, one of the consequential adjustments which would be necessary to facilitate the introduction of the Final PAYE Deduction System referred to, is that the deduction allowed from the earnings of a married woman would need to be increased in two stages, from the R1 200 applicable in the 1980-'81 tax year, to R1 400 in 1981-'82, and to R1 600 in 1982-'83.

I trust that this concession will further reduce the real tax burden of women engaged in gainful employment or in a trade or profession. The loss of revenue for the 1982-'83 financial year is estimated to amount to R19 million.

I may add that the total loss of revenue as a result of the introduction of the Final PAYE Deduction System, including amounts already accounted for in the printed Estimates of Revenue, will aggregate no less than R109 million in a full year.

The effect of the final deduction system with its inbuilt standard deductions and rebates and increased deduction from a married woman's earned income, can best be illustrated by an example. Take the case of a married couple under the age of 60 years with no children, where the husband earns R4 000 and the wife R2 500 per year, a total of R6 500. In the tax year which ended on 28 February 1982, tax amounting to some R210 had been deducted in their case. In the present tax year ending 28 February 1983, total tax deductible will only amount to R109, and no further tax returns or adjusting assessments will be issued. I regard this to be a very meaningful concession to the lower income groups in South Africa.

Housing

As indicated earlier, the provision of adequate and sufficient housing remains a problem which enjoys a very high priority with the Government. Not only have substantial public funds been allocated over the years for the provision of housing, but employers have also been encouraged by means of tax concessions to assist employees in either acquiring their own homes or in obtaining rented accommodation.

The provision of adequate financial resources, particularly for housing for the lower income groups, is at present being studied in depth by an expert committee representing the private and public sectors under the chairmanship of the Deputy Minister of Finance.

The private sector will be called upon to make a much more substantial contribution towards solving this problem, but in the meantime I feel it appropriate for the Government to offer further tax concessions specifically to encourage the construction of new accommodation for rent, at present at a premium throughout the country.

Various schemes and suggestions have been researched, but most were found to be either impracticable, too open to abuse, or even in conflict with sound taxation principles.

I am prepared, nevertheless, to offer the following concessions to investors who plan on erecting accommodation for rent: The annual depreciation allowance of 2% at present applicable to new industrial buildings will be extended to include all new housing projects which offer not less than 5 family housing units for rent. This will apply to all qualifying housing projects the erection of which commences on or after 1 April 1982.

In addition I wish to propose that an initial allowance of 10% of the cost of the project be allowed as a deduction from income in the year in which the project is completed and the accommodation is first let to tenants.

If the developer of the housing project should dispose ofsuch property either by means of an outright sale of the whole project or through sectional title selling of individual units, or in any other way, the allowances previously granted will be recouped and included in his taxable income. Details of the allowances will be contained in the Income Tax Bill which will be presented to Parliament later in the session.

I am confident that these concessions will stimulate the provision of accommodation for rent for the benefit of those dependent on such accommodation, and will assist investors materially with their cash flow prolems and return on investment.

It is estimated that the loss of revenue which this concession will entail in 1982-'83 will not exceed R1 million, but it could amount to approximately R500 000 for each R10 million invested in such projects in a full year.

Cinematograph films tax

The cinematograph films tax has been in operation in its present form since 1960. It is imposed at the rate of 3 cents on admission tickets of more than 35 cents, and has remained unchanged over the years. The tax has never been a substantial contributor to the State coffers and, in fact, the yield has declined dramatically over the last five years; from for the April issue and probably for further issues during the year.

It is imperative that the shortfall of R597 million be financed in a non-inflationary manner, most suitably by way of taxation. Various options are open to me in this respect, but considering all the positive and negative effects of the various taxes, a choice had to be made as to the most desirable package under present-day and expected conditions.

I wish to turn, then, to the additional taxation proposals. As Henry Ward Beecher so aptly states it: "In this world it is not what we take up, but what we give up, that makes us rich". Let us not give up grudgingly for the rewards will be plentiful.

Ad valorem excise duties

In 1978 certain *ad valorem* duties were imposed on less essential goods such as jewellery, photographic equipment, furs and the like. I feel it essential for these items to make a further contribution to the State coffers and wish to propose that the present *ad valorem* duties on certain locally produced gods as well as their imported equivalents be raised from 20% and 25% to 25% and 30%, respectively.

This proposal is expected to yield additional revenue of some R28 million in the 1982-'83 financial year and should also assist in curbing consumer demand. The increased duties will become effective as from 25 March 1982 and will be applicable to all imported goods concerned which have not been cleared for home consumption before that date and to all similar locally manufactured goods which by tomorrow have not been removed from the premises of manufactures and owners of warehouses licensed by the Commissioner for Customs and Excise.

Advertising

General sales tax

General sales tax is levied on a wide variety of commercial and industrial services, for example repair services, the services of tailors, hairdressers, launderers, photographers, signwriters and printers, to mention only a few. The omission from this list of advertising services is somewhat anomalous and I feel that the taxation of such services for the purpose of producing revenue is fully justified and will not prove to be unduly burdensome.

It is, therefore, proposed to amend the Sales Tax Act to bring advertising services within the ambit of the Act as from 1 August 1982. There may be certain practical problems in this regard and I have, therefore, instructed the Commissioner for Inland Revenue to liaise with the advertising industry and media in order to iron out these problems before the legislation is drafted.

The additional revenue from this source is estimated at R31 million for a full year and at R20 million for the current financial year.

Company tax

During 11 of the last 14 years a surcharge ranging from 2.5% to 10% was imposed on the income tax payable by companies. In addition, in most of these years a loan levy was also applied. The present surcharge on the basic rate of 40% amounts to 5%, which makes the effective rate of tax on all companies excluding gold and diamond mining companies – 42%.

This is a low rate by world standards. In view of the fact that basic company tax rates have remained unchanged since 1970, I propose that the present 5% surcharge be incorporated in the basic rate. I propose, further, that a surcharge of 10% be levied on the new basic rate for all companies excluding gold and diamond mining companies.

The additional tax that will be collected by the increase in the effective rate from 40 to 42% and the 10% surcharge is estimated at R400 million for a full year and at R300 million for the 1982-'83 financial year.

I do not propose to increase the basic râte of tax applicable to gold or diamond mining companies. Gold mining companies pay tax according to a formula which varies with profitability, and to which is added a 5% surcharge, while the tax on diamond mines is 45% plus a 5% surcharge, an effective rate of 47.25%.

In the circumstances prevailing, however, I consider it is not inappropriate to increase the surcharge in the case of the gold mining as well as the diamond mining companies by 10%, that is, from 5% to 15%, to provide in this way much needed additional revenue from which to meet, *inter alia*, the increased demands which will be made on the Exchequer in the form of assistance to the marginal gold mines. In this way the more profitable mines will contribute partly to the strengthening of the total mining industry.

The yield from the additional surcharge on gold and diamond mining companies is estimated to amount to R115 million in a full year and R105 million in the 1982-'83 fiscal year.

Long-term insurance companies

The taxable income of companies carrying on long-term insurance business cannot, because of the nature of their business, be determined according to normal accounting principles and it has always been neccessary to provide special rules for this purpose. Since 1959 the basic measure for the determination of taxable income from life insurers has been 30% of gross income derived from investments.

Over the years the long-term insurance industry has grown enormously and I feel it is only fair that it should make a greater contribution to the Exchequer. I propose, therefore, that the percentage of gross investment income used as a yardstick for measuring taxable income be increased from 30 to 40%.

The taxation position of the long-term life insurance industry is a matter which requires further investigation and I have instructed the Standing Commission on Taxation Policy and the Commissioner for Inland Revenue to consider the matter in depth during the recess in consultation with the whole industry and to report as soon as practicable.

The additional revenue to be collected during the current financial year as a result of this proposal is estimated to amount to R38 million.

Loan levy on individuals

The additional tax that can be collected based on the proposals I have just made amounts to R491 milion which still leaves me with a deficit of R106 million.

Few will differ from Thomas Jefferson when he remarked: "The purse of the people is the real seat of sensibility. Let it be drawn upon largely, and they will listen to truths which could not excite them through any other organ."

I wish thus to propose, finally, the imposition of a 5% loan levy on income tax payable by individuals, but subject to exempting the following taxpayers:

(a) Persons of all age groups whose incomes are R7 000 or less. These taxpayers, the majority of whom will fall under the Final PAYE Deduction System to which I referred earlier on, will be taxed at a fixed rate. I do feel that no further loan levy should be added to their tax;
(b) Persons, other than those I have just mentioned, whose basic normal income tax before the addition of loan levy amounts to R150 or less; and
(c) in the Year of the Aged, persons who are 70 years of age and older and whose taxable incomes exceed R7 000 but do not exceed R15 000 per annum, though remaining liable for normal income tax, will not be liable for loan levy.

Not only will the levy yield the revenue required to leave me with a small surplus for the 1982-'83 financial year, but it should also contribute, albeit moderately, to curb consumer demand by reducing personal disposable incomes and thus help in the fight against inflation. Additionally, it has the advantage that it does not presuppose an increase in the marginal rates of tax which I have striven so hard to bring down to, and keep at, lower and more realistic levels.

The levy is a compulsory loan to be repaid within a maximum period of 7 years, at simple, tax-free interest. Up to now the rate of interest has been 5% per annum, but I now propose that this rate be raised to 8%.

The yield expected from the loan levy in the 1982-'83 financial year will amount to around R115 million and R157 million for a full financial year.

After all these revenue proposals have been taken into account, there will remain a small surplus of R9 million.

Developments in Latin America

PERU: NEW TAX AMENDMENTS

By Pedro Massone *

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1. IN GENERAL

Law No. 23,337 of 14 December 1981, published in the Official Journal *El Peruano* on 15 December 1981, introduced tax amendments affecting the recent tax reform discussed in my recent article, "The Peruvian Tax Reform (1981)", in this *Bulletin*.[1]

The changes refer to the tax code, income tax, property tax, general tax on sales, excise tax, mining taxation, customs duties and some other subjects. The principal changes are discussed in the following sections.

2. INCOME TAX JURISDICTION

Persons (individuals or legal entities) that under the provisions of the income tax law are domiciled in Peru are taxed on their world-wide income. The nationality of individuals, the place where entities are organized and the income-producing source are in this respect irrelevant. Persons not domiciled in Peru and their branches, agencies or permanent establishments in Peru are taxed on their Peruvian-source income only.

The foreign income tax paid abroad on foreign-source income is creditable against the liability to Peruvian income tax. The credit is limited to: (a) the tax actually paid abroad; and (b) the Peruvian tax which would result if the average (effective) rate applicable to world-wide income were applied to foreign-source income only.

For income tax purposes, legal entities include branches, agencies and *any other permanent establishment* in Peru belonging to sole proprietorships, companies or entities of any kind established outside Peru.

3. DEDUCTION OF LOSSES

Taxpayers domiciled in Peru can set off Peruvian-source losses against Peruvian-source income. They can also set off foreign-source losses against foreign-source income. They cannot, however, set off their foreign-source loss against Peruvian-source income. Only Peruvian-source losses can be set off against income arising in subsequent periods (carry over).

4. MINING TAXATION

The Mining Law is amended in order to specify that concessionaires are subject to the following taxes and duties:

- surface and registration duties;
- the income tax;[2]
- the tax on goods and services for the period during which it was in force (i.e. up to 31 October 1981);
- the general tax on sales as far as transactions subject to this tax are performed;[3]
- the "special tax" levied on exports of traditional products in place of the tax on goods and services;
- the tax on considerations for the rendering of personal services;
- the additional tax on sales levied on exports of minerals listed by the law, which was established in Legislative Decree No. 33 of 21 February 1981;
- the 2% surtax on behalf of the *Fondo de Compensación Nutricional* except where the taxpayer has concluded a contract with the government by means of which a guarantee has been granted that taxation rules will remain unchanged for a certain period of time;
- the taxes levied on behalf of the National Fund for Housing;
- social security contributions; and
- the tax on the distribution of electric power and running water, which was established in Legislative Decree No. 163 of 12 June 1981.

Concessionaires are exempt from taxes other than those listed above.

5. TAXATION OF CAPITAL GAINS

Taxable capital gains include gains arising from the transfer of property belonging to legal entities organized in Peru or to permanent establishments of enterprises organized abroad that perform in Peru activities that produce third category income. Other rules on the taxation of capital gains continue in force.

6. TAXATION OF INCOME DERIVED BY NON-DOMICILIARIES

Dividends paid to beneficiaries not domiciled in Peru are

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1. 36 *Bulletin* No. 4 (1982) at 148.
2. The income tax is levied, as regards mining activities, under ordinary rules of the Income Tax Law, with several deviations therefrom, as explained in "The Peruvian Tax Reform (1981)", Section III. B.
3. Most minerals are specifically exempt from the general tax on sales.

subject to a 40% withholding tax which is a final tax (was 30%).

For income taxation purposes, it is presumed that loans expressed in foreign currency produce an interest of not less than the average "Libor" rate for 6-month deposits, for the second semester of the preceding year. This rule does not apply in those cases already excluded from the presumption of interest under the income tax law enacted in June 1981.[4]

Royalties paid to beneficiaries not domiciled in Peru are subject to a 55% withholding tax which is final (was 25%).

7. PROPERTY TAXATION

The property tax on non-business real estate due for the year 1982 shall be calculated on the basis of the amount due for the year 1981, increased by 40%. This rule does not apply to dwellings the rent of which is frozen.

8. SALES TAXATION

The coverage of the general tax on sales is extended to include production services.

For purposes of the excise tax *(Impuesto Selectivo al Consumo)*, enterprises are deemed to be economically connected, in addition to instances specified in previous legislation, if more than 30% of the capital of two or more enterprises belong to persons who are common partners of said enterprises.

9. CUSTOMS DUTIES

The Executive Branch is vested with the power to revise the customs tariff. Moreover, imports of goods carried out during 1982 are subject to a surcharge representing 15% of the old customs tariff. Imports made by the government are exempt from the surcharge.

10. ADJUSTMENT FOR INFLATION

The capitalization of the net appreciation resulting from the revaluation of fixed assets carried out under the law (partial adjustment for inflation) is subject to a tax of 5% of the capitalized sum. This tax is paid by the company concerned. The capitalization shall be carried out during the first semester of every year as regards the revaluation made at the end ot the preceding year.

The capitalization to be carried out in 1982 shall include any appreciation resulting from prior revaluations, which has not been capitalized yet.

11. TAX INCENTIVE MEASURES

The Executive Branch shall prepare a bill containing a revised statute for tax incentives which shall preserve the system of tax credits currently in force.

While the approval of the new statute for incentives is pending, some of the current benefits are reduced, i.e.;

- indexes of selectivity included in Decree Law No. 22,401 are reduced;
- the capitalization of reinvested profits shall be subject to income tax at a 5% rate unless a higher tax is due under previous legislation;
- exemptions from the tax on business net worth granted by old laws are reduced to 50%. This reduction does not affect benefits granted in Decree Law No. 2 of 17 November 1980 to agriculture and activities that are allowed to conclude contracts with the government by means of which a guarantee is granted that taxation rules will remain unchanged for a certain period.

4. E.g. the presumption does not apply to loans granted by non-domiciliaries from abroad.

IFA NEWS

FINNISH BRANCH

The Board of the Finnish Branch of IFA met on 5 March 1982. The Board discussed, among other things, applications for membership and resignations. On 1 January 1982 the Finnish Branch had 52 individual members, which number did not change during the first two months of 1982. The Board decided to send the Resolutions of the Berlin Congress[1] to the Ministry of Finance and the National Board of Taxes for their information. It was also decided that a report of this Congress, to be prepared by the Secretary, would be submitted for publication in the Taxation magazine.

The Annual Meeting was held on 20 April 1982. Professor Andersson and Mr. Pallonen who were appointed as national reporters for the Montreal Congress discussed their reports.

The Finnish Branch of IFA will attempt to organize a group trip to Montreal in September.

1. See for the text of these resolutions 35 *Bulletin for International Fiscal Documentation* No. 12 (1982) at 544-546.

[continued on page 274]

UNITED STATES:

Income of Foreign Corporations Subject to Tax in the U.S.

by Piroska E. Soos*

In Revenue Ruling 82-16,[1] the United States Internal Revenue Service ("I.R.S.") applied the provisions of Subpart F (Sections 951-964) of the U.S. Internal Revenue Code ("I.R.C.") which is designed to prevent tax avoidance by U.S. persons (individuals and entities) that seek to reduce their U.S. tax liability by conducting part or all of their business operations through foreign subsidiaries. I.R.C., Section 951(a) provides, inter alia, that if a person is a U.S. shareholder of a "controlled foreign corporation" and owns stock in the corporation on the last day (in a taxable year during which a foreign corporation is a controlled foreign corporation for an uninterrupted period of 30 days or more) on which the corporation is a controlled foreign corporation, such person must include in his gross income his pro rata share of the corporation's "Subpart F income".

I.R.C., Section 957(a) defines a "controlled foreign corporation" as any foreign corporation of which more than 50% of the total combined voting power of all the classes of stock entitled to vote is owned directly or indirectly by U.S. shareholders on any day during the taxable year of such foreign corporation. "Subpart F income" is defined in I.R.C., Section 952 and includes, among other things, certain sales income and certain dividends, interest and royalty income.

Revenue Ruling 82-16 involved a U.S. corporation, P, and two foreign corporations, S and S-1. Under the rules of direct and indirect ownership in I.R.C., Section 958(a), P was deemed to own 70% of S and 70% of S-1. The following diagram illustrates the relationship among the corporations.

P ---70% ownership---→ S (corporation organized under laws of country X)

(U.S. corporation)

100% ownership ↓

S-1 (wholly-owned subsidiary organized under the laws of country Y)

During its tax year ending on 30 September 1980, S-1 had "Subpart F income" of 100x dollars and other income of 50x dollars. S-1 also had accumulated earnings and profits in excess of 250x dollars, none of which was attributable to amounts previously included in P's gross income under I.R.C., Section 951(a). On 30 September 1980, S-1 distributed 200x dollars in cash to S, all of which was "Subpart F income" in the hands of S.

Under I.R.C., Section 951(a), P must include in its gross income for U.S. tax purposes its pro rata share of the "Subpart F income" of both S and S-1. However, in the absence of a specific provision stating otherwise, P would be taxed twice on its pro rata share of 100x dollars since the same 100x dollars was "Subpart F income" for both S and S-1. I.R.C., Section 959(b) prevents this result by providing that, for purposes of Section 951(a) the earnings and profits of a controlled foreign corporation attributable to amounts that are, or have been, included in the gross income of a U.S. shareholder under Section 951(a) shall not, when distributed through a chain of ownership described under Section 958(a), also be included in the gross income of another foreign corporation in the chain for purposes of applying Section 951(a) to the other controlled foreign corporation with respect to the U.S. shareholder.

The issue in the Revenue Ruling related to the words "amounts that are, or have been, included in the gross income of a U.S. shareholder" in I.R.C., Section 959. Does the phrase apply to exclude 70x dollars (P's pro rata share of S-1's income included in P's income) from S's gross income? Or, does the phrase exclude the entire 100x dollars of S-1's earnings and profits that are attributable to the 70x dollars included in P's gross income?

The I.R.S. held that, under the facts in this case, 100x dollars of the dividends received by S from S-1 are excluded from S's "Subpart F income" for purposes of applying I.R.C., Section 951(a) to P, its U.S. shareholder. The I.R.S. said that the exclusionary language of I.R.C., Section 959(b) looks at the total amount of earnings and profits of the controlled foreign corporation that caused the U.S. shareholder to be in receipt of gross income under I.R.C., Section 951(a). In this case, it was 100x dollars of S-1's earnings and profits that caused P to be in receipt of 70x dollars of gross income.

The I.R.S. found that if the exclusion of I.R.C., Section 959(b) were limited to 70x dollars, P would in fact have to include more than its pro rata share of S-1's income. If only 70x dollars were excluded, the remaining 30x dollars would be included in S's "Subpart F income", and P would have to include in its gross income its pro rata share of 30x dollars, i.e. 21x dollars (70% × 30x dollars). Thus, the total amount includible in P's gross income as a result of the 100x dollars would be 91x dollars (70x + 21x dollars).

The I.R.S. noted that I.R.C., Section 959(b) was enacted for the specific purpose of preventing the income of a controlled foreign corporation, which income had once been included in the gross income of a U.S. shareholder, from being included in the gross income of the U.S. shareholder a second time when the income is distributed to another controlled foreign corporation. This purpose could be achieved only by excluding 100x dollars from S's "Subpart F income".

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1. Published in *Internal Revenue Bulletin* No. 1982-5 of 1 February 1982 at 12.

INDIA:

How Progressive are the Direct Taxes?

by G. Thimmaiah*

1. INTRODUCTION

In India taxation has been used to promote multiple objectives: increase the rate of domestic savings, reduce inequalities of income and wealth and maintain price stability. The first objective was attempted through "widening and deepening of the Indian tax system" so as to mobilise additional revenue for the purpose of investment in the public sector. Additional taxation measures were mainly intended to increase public sector saving by diverting increased income in the private sector (from conspicuous consumption) to public sector saving and investment. But in the 1970s empirical studies have shown that this has not actually happened in India.[1] In fact, both direct and circumstantial evidence go to prove that additional taxation has encouraged the government to increase its consumption expenditure much more than government savings.

In the case of price stability, taxation was justified on the basis of Keynesian macro-economic logic, namely, that taxation would reduce disposable income and hence effective demand and thus bring down prices. But here again, some empirical studies have shown that taxation, particularly indirect taxation,[2] instead of reducing demand, has simply added to the tax-pushed price rise; consequently the additional tax measures in the past 10 years or so have only added to price instability in the country.

In regard to the equity objective, the role of taxation in reducing inequalities of income and wealth has been rather overemphasised. During the Second Five Year Plan period, the big-push strategy of industrialisation emphasised the objectives of growth and equity. Growth was attempted through rapid industrial development, particularly by starting capital goods industries, and equity was supposed to be achieved through fiscal policy tools, particularly by levying steeply progressive rates of tax on income and wealth. Accordingly, for the first time a group of direct taxes was introduced based on the recommendations of Nicholas Kaldor which came to be known as the "integrated direct tax system". In addition to the then existing income tax and capital gains tax, wealth tax, estate duty, gift tax and expenditure tax were introduced during the Second Five Year Plan period. Since then, these taxes have continued to operate with various modifications and only expenditure tax has been removed.

Nicholas Kaldor provided a very appealing rationale for the equity objective of taxation in the following way:

> An effective system of progressive direct taxation is vital to the survival of democratic institutions in India. The need for this arises not merely on financial grounds – to raise adequate resources for purposes of accelerated economic development – but in order to bring about the degree of social cohesion and co-operation that is essential for the successful functioning of a democratic system. In a community where there is such a wide gap between the position of a privileged minority of well-to-do and the vast majority who live in dire poverty, social cohesion can only be achieved if economic inequality is effectively lessened and the tendency towards increasing concentration of wealth is effectively counteracted. This can only be done through the instrument of taxation. It is in any case inevitable that heavy burdens should be laid on the broad masses of the population if India is to attain a satisfactory rate of development in the coming decades. it will not be possible to carry through the programme successfully with the consent and co-operation of the people if the privileged minority of the well-to-do are not made to bear a fair share of this burden. Moreover, in matters of taxation, like in the administration of the law, it is not enough that justice should be done – it must also be seen to be done. If owing to defects in the tax laws, or in their administration, highly progressive taxes of wealth and income have no visible effect on the prevailing economic inequality, or in the standards of living of the rich, the mere enactment of advanced tax legislation will prove fruitless.[3]

The Government of India took this advice very seriously and relied too much on direct taxes to reduce inequalities of income and wealth in the country. What is more, by introducing many direct taxes together, the Government of India tried to convince the majority of the vast masses that the richer people were bearing a very high burden of taxation and therefore the masses should also contribute, to whatever extent possible, through indirect taxation for the development effort of the country. This led to an enormous increase in the rates and coverage of indirect taxation. Such an unprecedented increase in indirect taxation also gave a lever to the private sector, which has been protected from foreign competition, to increase the profit through pushing up prices. While the Government was lulled to complacency on the assumption that increased taxation would reduce consumption and bring down the price level and also that the system of integrated direct taxes would prevent evasion of direct taxation and reduce inequalities of income and wealth, in actual practice prices went on rising as and when taxes were increased and the really rich self-employed income earners went on evading direct taxes. This is the story of postwar tax policy in India. After a period of two decades it has come to be realised that inequalities of income have increased and mass poverty has only spread. Several explanations are given for these not so unexpected economic

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1. See for details G. Thimmaiah, *Studies in Indian Public Finance* (New Delhi, Kalyani Publishers, 1979).
2. Ibid.
3. Nicholas Kaldor, "Tax Reform in India", in R.M. Bird and O. Oldman (eds.), *Readings on Taxation in Developing Countries* (Baltimore, The Johns Hopkins Press, 1972), p. 272.

consequences. Recognising this fact, the Fourth Five Year Plan emphasised restructuring the plan priorities and also the composition of the goods produced in the country with a view to achieving growth with equity. The Fourth Plan also started some anti-poverty programmes which have been continued even in the Fifth and Sixth plans.

While the effect of indirect taxes and the overall additional tax measures on public sector saving and the price level have been examined elsewhere, an attempt is made here to assess the effect of direct taxes on the inequalities of income and wealth in India. This is done by measuring the progressivity of direct taxes in India.

2. MEASUREMENT OF PROGRESSIVITY

For the purpose of judging the progressivity of tax, the average rate and marginal rates are traditionally used. Thus, over a given range of ascending income levels, if the average rate and marginal rates are equal, the tax is considered proportional; if the marginal rate is greater than the average rate, it is progressive; and if the average legal rate is greater than the marginal rate, it is regressive. However these refer only to legal rates which exist in law, but which in actual operation may not satisfy these conditions. In other words, what is important from the point of view of judging the progressivity of direct taxes is the comparison of average effective and marginal effective rates. These rates are obtained on the basis of actual amount of revenue collected from the taxpayers at different income levels. Though the progressivity of taxation is measured in terms of average progressivity, marginal rate progressivity, and tax liability progressivity, in order to know the effect of direct taxes on the inequality of income and wealth, we need to have some summary measure which has some relation to the popularly used measure of inequality, namely, the Lorenz curve. R.A. Musgrave[4] has suggested a measure in which the inequalities of pre-tax and post-tax incomes are compared and the effect of a tax system on the inequality of income is measured. Recently, D.B. Suits[5] and N.C. Kakwani[6] have also developed similar summary measures to know the impact of the tax structure on inequality of income. In this paper we have used Musgrave's measure as it will not only give us the impact of direct taxes on the degree of inequality, but also takes into account the impact of the statutory rate structure, the level of tax yield and the distribution of income.

Progressivity of direct taxes is measured with reference to their distributional effect. Following R.A. Musgrave, the incidence of taxation has come to be defined in terms of its distributional consequences. Accordingly, progressivity is supposed to reduce the inequality of post-tax income distribution. No doubt, for the purpose of knowing the progressivity and the impact of distribution of income, not merely the incidence of the overall tax structure but also the incidence of public expenditure should be considered. Only such a complete budget incidence will give the true picture of the distributional consequences of a government budget. However, it is also necessary to examine the impact of specific direct taxes on the distribution of income from the point of view of tax reform. The taxes which are traditionally considered as direct taxes – such as income tax, estate duty, capital gains tax, gift tax, wealth tax, etc. – are supposed to fall on those people on whom legal liability is indicated and established. It may be noted that the effectiveness of these taxes in reducing the inequality of income depends upon the nature of the progressive structure of the tax rates. In the case of Musgrave's measure, first the gini-coefficient of income distribution before tax, (G), is estimated. Then the gini-coefficient of post-tax income distribution, (G*), is estimated and the ratio of the latter to the former, (G*/G), will give the overall progressivity of the tax. The ratio (G-G*/G), which may be called the coefficient of equalisation, will give us the effect of direct taxation on the distribution of income. If the ratio of the Gini coefficient of post-tax income distribution, (G*), to the Gini coefficient of pre-tax income distribution, (G), is greater than 1, the overall effect of a tax is progressive. If it is equal to 1 it is proportional, and if it is less than 1 it is regressive. Further, the higher the value of the coefficient of equalisation, (G-G*/G), the higher the redistributive effect of taxation.

3. PROGRESSIVITY OF DIRECT TAXES IN INDIA

Table 1 shows the changing composition of direct taxes in India. It may be observed that the income tax, which contributed almost 75% of the revenue from direct taxes, gradually declined in its importance to 18%. Correspondingly, the revenue importance of corporation tax has increased from 23% in 1950-51 to 71% in 1981-82. Of the remaining direct taxes, the revenue from wealth tax has been increasing in both absolute and relative terms. Even so, the revenue importance of direct taxes on individuals has been declining. This would suggest that direct taxes on individual income and wealth are declining as compared to direct tax on corporate income, thereby making them ineffective in achieving the equity objective.

Table 2 presents the summary measure of progressivity and the redistributive effect of direct taxes in India. The summary measure of progressivity is the one suggested by R.A. Musgrave which indicates that all direct taxes have been regressive as the values are less than 1. Perhaps wealth tax, estate duty, gift tax and capital gains tax can be considered to be proportional in view of the values of their progressivity measures being nearer unity. But in the case of individual income tax, it is definitely regressive as it is less than 1. What is more, the coefficient of equalisation which is presented in Table 2 shows that the income tax, though it had a more equalising effect than other direct taxes, is still greatly inadequate to reduce the inequality of income distribution among direct tax assessees. In the case of wealth tax, the equalising effect is almost absent. And in the case of other direct taxes it is negligible. This suggests that direct taxes did not have a significant equalising effect to reduce inequalities of income distribution among the assessees to direct taxes in India.

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4. *The Theory of Public Finance* (Tokyo, McGraw Hill Co., 1959).
5. "Measurement of Tax Progressivity", *American Economic Review*, September 1973.
6. *Income Inequality and Poverty: Methods of Estimation and Policy Applications* (New York, Oxford University Press, 1980).

Table 1
Composition of direct taxes in India

(Rs. crores)

Year	Income tax	Corporation tax	Estate duty	Wealth tax	Gift tax	Other direct taxes	Total direct taxes
1950-51	132.73 (74.97)	40.49 (22.87)	–	–	–	3.81 (2.16)	177.03 (100.00)
1951-52	146.19 (76.71)	41.41 (21.73)	–	–	–	2.97 (1.56)	190.57 (100.00)
1955-56	131.35 (76.01)	37.04 (21.44)	1.81 (1.05)	–	–	2.60 (1.50)	172.80 (100.00)
1960-61	167.38 (56.60)	111.05 (37.55)	3.09 (1.04)	8.15 (2.76)	0.89 (0.30)	5.18 (1.75)	295.74 (100.00)
1965-66	271.80 (45.02)	304.84 (50.50)	6.66 (1.10)	12.05 (2.00)	2.27 (0.38)	6.06 (1.00)	603.68 (100.00)
1970-71	473.20 (53.97)	370.50 (42.26)	7.90 (0.91)	15.30 (1.74)	2.40 (0.27)	7.50 (0.85)	876.80 (100.00)
1975-76	1214.40 (54.65)	861.70 (38.78)	11.70 (0.53)	53.70 (2.42)	5.10 (0.23)	75.40 (3.39)	2222.00 (100.00)
1980-81	504.42 (25.32)	1310.79 (65.79)	3.93 (0.20)	67.43 (3.38)	6.51 (0.33)	99.34 (4.98)	1992.42 (100.00)
1981-82 RE	503.12 (18.24)	1962.00 (71.12)	(0.02)	75.00 (2.72)	6.75 (0.24)	211.18 (7.66)	2758.55 (100.00)

Notes:
1. 1 crore = 10,000,000.
2. Figures in brackets refer to percentages.
3. Other direct taxes include stamps and registration, land revenue, interest tax and expenditure tax.

Source: RBI Bulletins and *Reports on Currency and Finance.*

Table 2
Progressivity and redistributive effect of direct taxes in India

Year	Income tax		Wealth tax		Estate duty		Gifts tax		Capital gains tax	
	$\frac{G^*}{G}$	$\frac{G-G^*}{G}$	$\frac{G^*}{G}$	$\frac{G-G^*}{G}$	$\frac{G^*}{G}$	$\frac{G-G^*}{G}$	$\frac{G^*}{G}$	$\frac{G-G^*}{G}$	$\frac{G^*}{G}$	$\frac{G-G^*}{G}$
1957-58	.07844	0.2156	–	–	–	–	–	–	0.9525	0.0475
1958-59	0.9242	0.0758	–	–	–	–	–	–	0.9518	0.0482
1959-60	0.8492	0.1508	–	–	–	–	–	–	0.9504	0.0496
1960-61	0.8248	0.1751	–	–	–	–	–	–	0.9696	0.0303
1961-62	0.8467	0.1533	0.9968	0.0033	0.9379	0.0621	0.9768	0.0232	0.9521	0.0479
1962-63	0.8392	0.1608	0.9961	0.0039	0.9371	0.0629	0.9721	0.0279	0.9638	0.0362
1963-64	0.8397	0.1603	0.9952	0.0047	0.9236	0.0764	0.9816	0.0184	0.9701	0.0299
1964-65	0.8452	0.1548	0.9959	0.0041	0.9436	0.0564	0.9432	0.0567	NA	NA
1965-66	0.8424	0.1476	0.9964	0.0035	0.9427	0.0573	0.9279	0.0721	0.9457	0.0543
1966-67	0.8400	0.1599	0.9960	0.0040	0.9142	0.0858	0.9318	0.0682	0.9551	0.0449
1967-68	0.8318	0.1682	0.9956	0.0046	0.8837	0.1163	0.9510	0.0489	0.9670	0.0329
1968-69	0.8591	0.1409	0.9962	0.0040	0.9221	0.0779	0.9319	0.0680	0.9607	0.0393
1969-70	0.8304	0.1696	0.9959	0.0041	0.8881	0.1119	0.9422	0.0578	0.9642	0.0358
1970-71	NA	NA	0.9960	0.0040	0.9105	0.0895	0.9712	0.0288	NA	NA
1971-72	0.7607	0.2393	0.9951	0.0049	0.9191	0.0809	0.9427	0.0573	0.9646	0.0354
1972-73	0.7860	0.2140	0.9966	0.0034	0.9113	0.0887	0.9383	0.0617	0.9145	0.0855
1973-74	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA
1974-75	0.7098	0.2092	0.9955	0.0046	0.9159	0.0841	0.8964	0.1036	0.8922	0.1078
1975-76	0.7909	0.2091	0.9957	0.0043	0.9085	0.0915	0.9277	0.0723	0.8953	0.1047
1976-77	0.8008	0.1992	0.9970	0.0031	0.9272	0.0728	0.9224	0.0776	0.8872	0.1128
1977-78	0.7009	0.2991	0.9944	0.0054	0.9259	0.0741	0.9224	0.0776	0.6935	0.3065
1978-79	0.8102	0.1898	NA	–	NA	NA	NA	NA	0.8887	0.1113

Notes:
1. NA: Data are not readily available for these years and hence the relevant measures are not estimated.
2. $\frac{G^*}{G}$: is the summary measure of progressivity suggested by R.A. Musgrave.
3. $\frac{G-G^*}{G}$: is the equalisation coefficient as proposed by Hiromitsu Ishi.

We have also examined average rate – marginal rate progressivity. (However the results are not presented here as they run into several pages.) There also we find evidence of regressivity. In other words, though the summary measure of progressivity indicates the overall progressivity over the entire range of income levels, even the marginal rate progressivity does not clearly indicate progressivity at different ranges of income levels. It is quite possible that a tax may be progressive at different levels of income but may not be progressive over the entire range of income levels. However, both the summary measure of progressivity and the average – marginal rate progressivity indicate that all the direct taxes in India have not been progressive so as to reduce inequalities of income and wealth.

It should, however, be noted that these direct taxes have been operating in a situation of rising prices. Rising prices themselves operate as some sort of regressive tax, and in order to know the true nature of the progressivity we have to eliminate the impact of inflation on the progressivity of these taxes. However, we have not been able to separate the regressivity of inflation from the regressivity of direct taxes. Even so, one would expect from the tax rate structure that some sort of progressivity would prevail. But the average effective rates and the marginal effective rates indicate that the effective rate progressivity has been regressive in India.

4. EXPLANATIONS FOR THE ABSENCE OF PROGRESSIVITY

After establishing he negligible equalising effect of direct taxes in India, it is necessary to search for the reasons for such absence of progressivity. Three reasons may be given to explain this phenomenon:

(1) Though the legal rates have been steeply progressive, the effective rates have been made regressive owing to various exemptions, allowances, deductions and so on. In other words, "tax expenditure measures" which are built into the direct tax system have distorted the legal rate structure and made them regressive.

(2) Tax evasion seems to be evident as the marginal and average effective rates become lower at the higher levels of income and wealth.

(3) The extent of tax avoidance under legal protection and the ever increasing arrears of assessment and of collection (as is evident from Tables 3 and 4) do indicate that, at the higher levels of income and wealth, people resort to legal remedies because of defective assessment and, as a result, the actual tax liability becomes far less than the expected legal liability. Consequently, the originally designed tax loses its progressivity element over time, apart from the government losing the revenue.

Thus a combination of these factors have been operative in the country to make the direct taxes ineffective in their equalising effect. The policy implication of the foregoing findings is simple, namely, to recognise the reality of the situation. It is better to admit the fact that the direct taxes in the country cannot be used to reduce inequalities of income and wealth, rather than to proclaim repeatedly that they are intended for that. This is mainly because the coverage of these taxes is so small that it is meaningless to think of using such taxes – which cover a small proportion of the active population in the country – to reduce the inequalities of income in the country as a whole. The actual operation of the tax laws has shown that the average and marginal effective rates have been quite different from the legal rates and as a result the expected equity even among those whose income and wealth are assessed for direct taxes is not achieved. It would be better to recognise the fact that these direct taxes cannot reduce inequalities of income and wealth in this country, and, therefore, to justify these taxes only from the point of view of raising revenue. Otherwise, great hopes will be raised, and in fact such hopes have been raised in the past, in the minds of the people in the name of achieving equity through steeply progressive taxation, which in fact has not been achieved. Hence, instead of raising expectations and dashing them to the ground without achieving the intended objective, it would be better to admit the fact that direct taxes in the Indian situation cannot achieve the objective of reducing inequalities of income in the country.

Alternatively, one might argue that we should reform the direct tax structure in such a way as to cover more people, to plug legal loopholes not only to prevent evasion of tax payment but also to reduce tax avoidance through tax planning. We would consider such arguments as merely academic in the Indian politico-economic institutional setting.

Table 3 (Number of assessments)
Arrears of assessment of direct taxes in India

Year	Income tax	Wealth tax	Estate tax	Gifts tax
1950-51	528,070	–	–	–
1955-56	539,832	–	–	–
1961-62	712,402	15,499	4,210	2,117
1966-67	2,346,531	74,232	9,798	6,872
1971-72	1,123,705	172,044	11,945	13,825
1972-73	1,392,665	198,677	13,408	16,986
1973-74	1,719,597	238,732	14,969	21,106
1974-75	1,677,481	244,224	20,084	26,305
1975-76	1,726,683	255,810	25,470	30,438
1976-77	1,741,838	288,949	27,256	22,580
1977-78	1,537,542	314,224	28,287	22,925
1978-79	1,925,564	331,561	27,802	21,807
1979-80	2,299,265	432,988	34,891	27,403

Note: Wealth tax, estate duty and gifts tax were not in operation in 1950-51 and 1955-56.
Source: Anil Kumar Jain, "Central Direct Taxation: Administrative Problems", *Eastern Economist*, 12 February 1982.

Table 4 (Rs.crores)
Arrears of collection of direct taxes in India

Year	Income tax	Wealth tax	Estate tax	Gifts tax
1970-71	738.77	12.01	15.71	2.38
1972-73	790.02	25.46	15.29	3.61
1973-74	815.60	29.03	15.75	3.60
1974-75	935.96	75.56	13.86	5.01
1975-76	993.79	82.38	15.31	5.22
1976-77	873.56	52.75	15.56	5.90
1977-78	989.87	56.51	17.52	6.97
1978-79	910.65	184.08	17.11	17.72
1979-80	1011.85	180.53	17.23	15.77

Source: Anil Kumar Jain, op.cit.

HONG KONG:

Budget 1982-83

Extracts from the Budget Speech pronounced by the Financial Secretary, Mr. John Bremridge, on 24 February 1982

A detailed discussion of Hong Kong's tax system appears in the International Bureau of Fiscal Documentation's publication: TAXES AND INVESTMENT IN ASIA AND THE PACIFIC

1. I begin my first budget speech by acknowledging my debt to my predecessor who has left me a clean slate on which to draw. I am also grateful to my new colleagues in Government who have worked so hard on the budget, and have loyally pointed me in approximately the right direction, though the choice of paths is mine – even in a budget which naturally reflects governmental not personal policy. I cannot name them all, but they particularly include officers in Finance, Economic Services, Monetary Affairs, and Inland Revenue.

2. My speech deals with three main issues – where Hong Kong has been and why; the current state of the Government's accounts and my proposed estimates and tax concessions; and where Hong Kong then seems likely to go in 1982. It is supported by the accompanying cross referenced 1981 Economic Background and 1982 Economic Prospects, plus footnotes and appendices bound with the printed version.[1]

. . .

TAX PROPOSALS

74. I come now to my proposals on taxation. The estimated surplus for 1982-83 is $6.3 billion as against the revised estimate of $7.7 billion for 1981-82. Our reserves are now larger at $23 billion.

75. While there are several sources of increased or additional revenue fairly open, with tobacco and alcohol only among the more obvious, I do not believe that it is ordinarily appropriate for the Government to raise taxation when it clearly does not need the money either for its immediate expenditure requirements or in order further to strengthen prudent reserves. While for years it has been argued in Hong Kong that in normal circumstances taxation should be fiscal in nature there may have to be exceptions. Higher taxes on motor vehicles and duties on petrol are possible examples. There are others. Common sense in such cases may indicate that the Government should consider not only its fiscal requirements but also the potential of taxation as a supplementary means of achieving other policy ends.

76. I believe that the new Capital Works Reserve Fund is a businesslike way of spreading unpredictable and often lumpy capital revenue from year to year against a current Public Works Programme four-year overhang of some $23 billion. In fact annuality (except as an important control concept) does not really play a part in major capital programmes, for we are not likely to stop large capital schemes in mid-stream unless in extraordinary circumstances.

77. With the C.W.R.F. established and initially funded, the surplus is estimated to drop to $3.7 billion in 1982-83. This presupposes that members will accept my recommendation that $11 billion should be appropriated in 1982-83 for the fund. While the creation of the C.W.R.F. has seemingly diminished the overall surplus on General Revenue Account, we should not allow ourselves to be seduced by this budgetary innovation into inconsistent fiscal behaviour.

78. I make no apology for referring frequently in this speech to the need for consistency in Government policies – and particularly taxation policies. While simultaneously observing our accepted guidelines it is reasonably consistent that I should propose to abate taxation in 1982-83 by some $1.37 billion, which compares with the figure of $1.25 billion a year ago. You will note that I do not use the irritating phrase 'give back', which presuppose that private monies are all at Government's beck and call.

79. My major concerns for 1982-83 include the need for appropriate monetary and fiscal counter-inflationary policies, the problems of industry, the continued development of Hong Kong as a major financial centre, and the less privileged. I also acknowledge the burdens of Mr Lobo's sandwiched society – the middle class who in Hong Kong as elsewhere tend to be a mainstay of the community. Finally I am well aware that capital revenue yield from future land sales is as enigmatic as it ever has been.

80. I thus propose ten tax concessions in four areas, which I believe reflect these concerns. They otherwise are mainly neutral in effect, and will promote our general economic well-being. In that state of well-being I include a sense of fair play, for good budgets must surely have some satisfying emotional content.

BUSINESS TAXATION

81. My first two concessions offer incentives for investment to the business sector of our economy and in particular to our manufacturers, who I believe should be further encouraged to expand their investment in new capital equipment. This is essential if our industry is to remain flexible and competitive. I am anyway well aware of the difficulties currently being experienced for example by many in the spinning, weaving, dyeing and finishing sectors. Members will recall that in order to encourage manufacturers to re-equip and upgrade their plant and equipment, Government last year introduced both improved annual depreciation rates and an increased initial allowance, which was raised from 25% to 35% in respect of expenditure incurred on the provision of plant and machinery.[2] Some have said that we did not go far enough and that we should permit a full 100% write-off in the year of acquisition as indeed is the practice in some other places. This would, however, be an expensive concession, which could not be contemplated in one single bound. Furthermore, bearing in mind Hong Kong's unusually low rates of tax fiscal relief alone will probably never be a conclusive incentive to incur expenditure on plant and equipment; other considerations such as a desire for improved production capacity, increased productivity, and particularly enhanced profitability are more likely to be the deciding factors. Nonetheless I accept that tax considerations play their part in the decision-making process; and our manufacturers still represent the backbone of our economy. Accordingly my first proposal is that the initial allowance should be further increased from 35% to 55% for expenditure incurred on the provision of qualifying plant and equipment.[3] The new initial allowance will apply to both final profits tax assessments for 1981-82 and provisional profits tax for 1982-83. The cost to the revenue of this increased allowance will be $354 million in 1982-83 and $180 million in a "full" year.

82. My second concession, which concerns the industrial buildings allowance, will benefit both manufacturers and those who invest in industrial property for rental income purposes. For just as it is important that our manufacturers should be encouraged to re-equip and upgrade their plant and equipment, so it is desirable that new plant and equipment, and particularly the workers who operate the machines, should be accommodated in modern and efficient factory premises.

83. The present legislation provides for the grant of industrial buildings allowances by reference to the cost of construction only: no account is taken of the profit element included in the price which the property developer charges to the purchaser for his new building. I propose therefore, that where a person carrying on a trade, which consists wholly or partly of the construction of buildings or structures with a view to their sale, sells a qualifying building in the course of that trade, before it is used, then the initial and annual allowances will be computed by reference to the net price paid by the purchaser and not by reference to the actual cost of construction.[4] The cost to the revenue of this concession will be $66 million in 1982-83 and $34 million in a "full" year; and the concession

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1. Not reproduced here.
2. B.S. 1981, paragraph 243.
3. Thus, for example, an item of weaving or spinning machinery already ranking for the annual rate of allowance of 30% will qualify for a write-off for profits tax purposes (initial and annual allowances taken together) of 68.5% in the year of acquisition.
4. Thus, assuming a factory building is constructed by a property developer at a cost of $8 million and sold to a corporate manufacturer for, say, $10 million (which could be a comparatively modest mark-up), then the tax saving to the manufacturer in the year of acquisition as a result of this concession would be $79,200 (i.e. tax at 16.5% on initial and annual allowances granted on the developer's profit of $2 million).

will again apply to both final profits tax assessments for 1981-82 and provisional profits tax for 1982-83.

INTEREST TAX

84. I turn now to the controversial issue of interest tax. When presenting his 1981-82 Budget Sir Philip made reference to the taxation treatment of foreign currency deposits and told this Council that an examination was in hand.[5]

85. In the course of our subsequent deliberations we once again concluded that for a variety of reasons there was no present case for the total abolition of interest tax; and that the case for the exemption of foreign currency deposits taken in Hong Kong was not clearcut, because it could lead to switching of funds from Hong Kong dollar deposits to foreign currencies with consequential pressure on the exchange value of the Hong Kong dollar. I have since received two reports prepared by the Hong Kong Association of Banks. The second of these gave information obtained from a survey of member banks, the general consensus of which was (hardly surprisingly) strongly in favour of a tax exemption for foreign currency deposits. These submissions acknowledged the probable fiscal consequences of repeal, but took the view that in the context of our total budgetary situation we could afford the loss in yields from interest tax. They also argued that the monetary and economic advantages, in particular the enhancement of Hong Kong's position as an international financial centre, could well outweigh the fiscal losses; and that such losses would in part at least be offset by increased profits tax yields from financial institutions. After long internal debate and much heartsearching we have come to the conclusion that the arguments for a partial repeal of the interest tax on pragmatic and economic grounds outweigh the fiscal arguments for its retention. The Government considers that the continuing growth of Hong Kong as an international financial centre is worthy of encouragement.

86. I therefore propose to exempt foreign currency deposits placed with licensed banks and registered and licensed deposit-taking companies from interest tax; and it follows that those institutions will no longer be under any withholding obligations in respect of such deposits. The original terms of reference for the examination envisaged that exemption would only be available for deposits of a minimum size, and would apply only to deposits placed with licensed banks and licensed deposit-taking companies. We have now come to the view, however, that it would best serve Hong Kong's interests if the exemption were extended to registered deposit-taking companies as well, thus giving to international investors who wish to use our services a wider range of choices. By the same token I have decided not to impose a minimum level of deposit. Any such limitation would necessarily have had to be arbitrary: if set too high it would have vitiated the objectives of the exemption; and if set too low could have been readily circumvented, for instance by groups of depositors joining together to meet the stipulated minimum. Furthermore a minimum level of deposit which was pitched high would be open to criticism on grounds of equity – helping only the rich investor at the expense of the man in the street. Consequently the exemption will apply to all foreign currency deposits placed with licensed banks and licensed or registered deposit-taking companies. And, I should add, not only is the charge to interest tax removed but also it is intended to provide a corresponding exemption from profits tax in respect of interest accruing on foreign currency deposits placed with these institutions by persons, whether corporate or non-corporate, carrying on a trade, profession or business in Hong Kong (other than the business of 'financial institution' as defined in the Inland Revenue Ordinance).[6] I must stress that the profits tax exemption will not apply to 'financial institutions' – for obvious reasons. The borrowing and lending of money at interest with a view to profit is the very essence of their business activities, and there is clearly no case for excluding those profits from charge.

87. Having thus decided to exempt interest on foreign currency deposits, there remained the problem to which I have already referred; that is the evident dangers for the Hong Kong dollar if depositors began significantly to move across the exchanges out of Hong Kong dollar deposits ino foreign currency deposits. It is also now a relatively simple matter for an investor to minimise his exchange risks at small cost by entering into what is known in the trade as a "swap" transaction – that is the coincidental purchase and resale of the foreign currency deposit. This practice moreover is clearly mushrooming.

88. Bearing in mind, however, that there is a cost element in minimising exchange risk exposure, we believe that it is possible to discourage widespread switching from Hong Kong dollar to foreign currency deposits; and this I propose to do by reducing the rate of interest tax on Hong Kong dollar deposits with licensed banks and registered and licensed deposit-taking companies from 15% to 10%. At this level the tax advantages of moving into foreign currency deposits will usually be small; indeed a switch could well be disadvantageous when measured against the costs of covering exchange risks. Much will depend, however, upon the relative movements of Hong Kong dollar and other interest rates. I do not incidentally propose to introduce a differential rate for profits tax on Hong Kong dollar deposit interest accruing to business depositors. The practical complications would be considerable and, in my view, not justified. Again it will be appreciated that the concessions now proposed apply only to deposits with banks and deposit-taking companies. Interest on other forms of indebtedness such as mortgages and private loans will continue to attract liability to tax at the standard rate of 15%, or 16.5% in the case of the profits of corporations who receive such interest as part of their trading profits.

89. The cost to revenue of exempting foreign currency deposits and of reducing the interest tax rate on Hong Kong dollar deposits to 10% is estimated to be $400 million in 1982-83, subject always to the influences which variations in interest rates from time to time and in the volumes of deposit business transacted might have on revenue yields.

90. It would be appropriate administratively to introduce these interest tax proposals with effect from 1st April 1982, that is at the commencement of the next fiscal year. As however there could be something of a hiccup in the financial sector in the intervening weeks, I have decided that it will be more intelligent to introduce the new exemption for foreign currency deposits and the reduced rate of 10% forthwith. To this end Your Excellency this morning signed an Order under the Public Revenue Protection Ordinance which will bring these proposals into force so as to apply to interest paid or credited on or after tomorrow, Thursday, 25th February 1982. It is my hope that the clamourings of the interest tax abolitionist lobby will now subside. But whether they do or not, we shall watch carefully the effects of the reliefs now to be introduced. Whatever the monetary and economic advantages may be, we realise that these reliefs introduce a new, untried and somewhat untidy dimension to the well tested fiscal balance of our tax system. If the imbalance which these new reliefs impart to the system is unduly exploited – for example by way of sophisticated gearing devices designed to eliminate or reduce substantially the profits tax liabilities of ordinary trading concerns – we shall have to consider whether the loss to revenue is still justified, or whether we have begun to pay too high a price for the economic advantages gained. It will also be a matter of experience whether 10% is an appropriate level.

PERSONAL TAXATION

91. Last year substantial increases were introduced in the level of allowances granted to those liable to salaries tax and to those who elect for personal assessment. I propose this year to introduce further concessions in the field of personal taxation because, as Sir Philip aptly put it last year, we have an ongoing commitment 'to review the system of personal taxation periodically, having regard to our current budgetary situation and to the need to maintain equity as between different income groups at a time when the growth of money incomes is leading to fiscal drag'.[7] If at some future time our revenue needs dictate an increase in the levels of taxation, I shall not hesitate so to address this Council. For the moment, however, I am satisfied that we can afford this year to review again the levels of our personal taxation allowances and to revise upwards the tax thresholds, that is the

5. B.S. 1981-82, paras. 295-296 . . . . . to consider the implications of the proposition 'that interest payable on deposits denominated in foreign currencies above a certain minimum size, accepted by institutions of a certain status (say, licensed banks and the proposed new category of merchant banks), be made exempt from tax and consequently, that the institutions concerned be made exempt from any withholding obligations'.

6. This profits tax exemption is a logical consequence of the decision to exempt foreign currency deposits from interest tax, and also recognises that business proprietors could with comparative ease remove surplus funds temporarily from their businesses thus legitimately avoiding the charge to profits tax whilst at the same time enjoying the interest tax exemption.

7. B.S. 1981, paragraph 223.

levels of the entry points into the tax net. Such concessions will ensure that those who would otherwise be brought into the tax net because of the effects of inflation on money incomes are kept out: they will pass on to some of those already in the tax net some of the benefits of our satisfactory budgetary situation: they will also mean that some are no longer liable to tax at all.

92. Firstly, I propose an increase in the level of personal allowances from $15,000 to $20,500 for single persons and from $30,000 to $41,000 for married persons. The present supplementary personal allowances of $7,500 for a single person and $15,000 for a married person will remain unchanged, and the available claw-back mechanism will continue to be zero rated. Thus taken together the basic personal allowance plus supplementary allowance will total $28,000 for a single person and $56,000 for a married couple; below these income levels there will be no liability to tax. The new allowances will be, therefore, very nearly 25% higher than the present levels fixed a year ago, and thus considerably in excess of the rate of inflation.

93. Secondly, I propose an increase in the child allowances from $7,000 to $8,000 (or by 14.3%) for the first child and from $5,000 to $5,500 (or by 10%) for the second child. I do not propose increases in the present allowances for the third to ninth children, which I consider remain appropriate.

94. Thirdly, I propose an increase in the dependent parent allowance from $7,000 to $8,000 (or by 14.3%), as before pitching this allowance at the same level as that for the first child. I do not propose to vary the criteria for the granting of this allowance.[8] I shall give further thought to the important social question of persuading children to support their ageing parents, of whom I am one.

95. If approved, my proposals for personal taxation allowances will be applicable to final salaries tax assessments (and for personal assessments also) for 1981-82 and to provisional salaries tax for 1982-83. The cost to the revenue in 1982-83, after allowing for the two-instalment system for the payment of provisional salaries tax, will be $509 million, equivalent to a substantial proportion (22%) of the estimated revenue from personal taxation. The cost in a "full" year is estimated to be $316 million at present levels of chargeable income.[9] I do not propose to dwell on the figures, but I suggest that close examination will demonstrate again that our system of personal taxation is extraordinarily modest in its impact. Indeed there can be few other places in the world which have both tax thresholds so high that the majority of the economically active are excluded from charge to tax, and a system which is so efficiently revenue productive (and, I might add, at an extremely low cost by world standards).

ESTATE DUTY

96. Finally I have three concessions relating to Estate Duty. But first I intend to use this opportunity to comment on certain criticisms of Estate Duty at large, which will also enable me to range more widely. It has been suggested that the Estate Duty legislation ought to be repealed because it is cumbersome and complex, its impact is easily avoided, it produces little revenue, and is difficult and expensive to administer.

97. The facts however are that the legislation is well understood by those who have to deal with it professionally, and by the officers of the department who administer it. As regards avoidance, all our direct taxes are susceptible to avoidance, based as they are on our limited territorial source criterion. On the whole because of our modest rates the majority of our entrepreneurs and others who use Hong Kong's excellent infrastructure of services, communications facilities and so on do not conduct their tax affairs as cynically as their counterparts in other places where high levels of taxation prevail. But I am bound to say that, if ever our taxation system ceases to be as revenue productive as it is now, we shall have to think seriously about plugging the leaks even if that means paddling into the muddy waters of highly complex fiscal legislation, which we have always avoided in favour of our simpler system.

98. In the year ended 31st March 1982 estimated estate duty collections are expected to be $294 million, which though not a significant sum measured against our total revenue yields, is a useful contribution to our total budgetary needs. Nor must we ever commit the cardinal error of being mesmerized by billions: it is an accumulation of small sums that matters, as every man and woman in the street knows. The cost of collection is under 1%, which is hardly an expensive operation. Finally, so the Commissioner informs me, the Estate Duty Office provides an excellent source of information on those who during their lifetime made little or no contribution to the Exchequer – because they evaded or cheated on taxes they ought to have paid. This final opportunity to seek and obtain some restitution from the estates of such people would in itself be justification for the retention of the estate duty, even if the yield from the duty itself were insignificant – which it is not.

99. But to return to my three concessions. Members will recall that last year we raised the estate duty exemption limit to $1 million in recognition of rising asset values. This year I propose firstly further to raise the exemption limit to $2 million: that is to say no duty will be payable on the estates of deceased persons who die possessed of net assets of a value below that figure. This increase may at first sight seem somewhat generous, but it recognises that asset values have continued to rise and is consistent with our low tax philosophy.

100. Secondly, one of the effects of successive increases in the exemption limit in recent years has been to make the initial impact of the estate duty rather more significant than it should be, and therefore inconsistent with our low tax philosophy. If my proposal to increase the exemption limit to $2 million is approved, the rate of duty applicable to estates between $2 million and $3 million under the present schedule (and subject, of course, to marginal relief) would be 17%. Therefore in order to reinstate the concept of graduality I propose to replace the present schedule of rates with a new schedule scaled from 10% on estates between $2 and $2.5 million to 18% above $4 million.[10]

101. Thirdly, I propose to exempt from duty altogether the principal matrimonial home of the deceased, where the deceased leaves a surviving spouse. This relief acknowledges the claim that sometimes there can be hardship for the surviving spouse because the home is subject to duty. While I know of no case where a widow has been obliged to sell the home in order to pay the duty, it seems logical in the context of our low tax philosophy to exclude it from charge.[11]

102. The cost to the revenue of these three proposals will be approximately $42 million in 1982-83 and an estimated $52 million in the following year.

OTHER MATTERS

103. Before I leave the subject of taxation I wish to comment on other matters on which I have received representations. (My office is of course always open to criticism or to new ideas.)

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8. At certain income levels those who contribute only the minimum qualifying annual contribution of $1,200 to a dependent parent can gain a tax advantage in excess of that sum; the majority of claimants probably make a rather larger contribution to the maintenance of their dependent parents.

9. These increased allowances will benefit an estimated 92,000 persons; 52,000 taxpayers who were previously liable and who will now be exempt, and a further 40,000 who would have become liable in 1982-83 but who will now be kept out of the tax net. This means that in 1982-83 there will be an estimated 218,000 salaried taxpayers, compared with some 310,000 who would have been liable without these new concessions. Furthermore, of those remaining in the tax net some 205,000 will benefit by way of reduced liability. About 13,000, or 6% of the total number in the tax net, will receive to benefit from these concessions and will continue to bear tax on their chargeable incomes at the standard rate of 15%. *This high income group continues to contribute well over half of the total yield from salaries tax.* Additionally an estimated further 55,000 persons who elect for the advantages of personal assessment will also benefit through reduced liability. Examples of the effects of these new allowances for persons at various income levels and in various personal circumstances are contained in Appendix E to the printed version of this speech; and at Appendix F there appears a table showing examples of the present and future effective rates of tax at different income levels for persons in various personal circumstances. Appendix G shows the income levels at which persons in various personal circumstances will become liable at the standard rate in future.

10. On estates between –

$2,000,001 and $2,500,000	10%
$2,500,001 and $3,000,000	12%
$3,000,001 and $3,500,000	14%
$3,500,001 and $4,000,000	16%
$4,000,001 and above	18%

11. The exemption will be administered by reference to rules which broadly follow the Property Tax owner-occupier exemption; and where there is more than one matrimonial home the estate's legal personal representative will be permitted to designate which property is to be the principal matrimonial home. But for the purposes of determining the appropriate rate of duty to be applied to the remainder of the estate, the matrimonial home will first be aggregated with the other dutiable assets and only thereafter excluded from charge.

104. They include allegations that our profits tax legislation enables the Commissioner to charge capital gains to tax. I am advised that this is not so; and the Commissioner assures me that he has never done so and has not the slightest intention of trying to do so. He does concede that there are occasions when he seeks to tax as income what the taxpayer prefers to think of as a capital profit. But there are remedies through the appeal process, if the Commissioner's view in such a case seems incorrect. It has also been represented that executors of deceaseds' estates are in some jeopardy in that the Commissioner could successfully recover from the personal assets of the executor taxes owed by the deceased. Again I am advised that this is not a correct interpretation of the law, and the department does not seek to recover taxes in default in this way. I have also been told that in certain circumstances dividends could be chargeable to profits tax. Once more, that is not a view to which the Commissioner subscribes. These, and other miscellaneous matters which have been placed before me, are not in any respect what could be described as burning issues. However, I have taken due note of them; if at some convenient time in the future it is thought that any of them has merit, or that there is indeed some legal doubt as to the proper interpretation of the existing legislation, steps will be takenm to put matters right.

105. The one proposition which has caused me sleepless nights is the contentious issue of separate taxation for married women. I have of course noted Sir Philip's concluding comments in the last year's debate.[12]

106. I am fortified by two other considerations. Firstly, the cost to revenue of separate taxation for married women would be about $200 million per annum. It would not be prudent to add this considerable sum to this year's total tax cuts, and it would therefore be necessary to sacrifice others of my proposals to make room for benefits for married women. I do not think it sensible that my overall reliefs should thus be distorted.

107. Secondly and fortuitously, the Commissioner for Inland Revenue has told me that because of the considerable changes proposed this year and the computer software problems inherent in a system of separate assessment his department simply could not cope with such a change. On pragmatic grounds, therefore, further tax changes this year are not possible.

108. Perhaps I protest too much. I will admit under pressure that as history moves on the arguments for and against separate taxation for women seem more evenly balanced, while deeply felt emotion rightly or wrongly can be as persuasive as logic. In fact the argument is not simple, for there are great practical problems involved. Nevertheless a dispassionate and pragmatic man should be able now to see which way the tide is running both in Hong Kong and elsewhere. Whether it should so run is another matter; but Canute proved the fallacy of relying on this sort of argument.

109. If, therefore, women members of this Council and some 50% of the population will bear with me this year, without of course making any promises or commitments and absolutely dependent on the situation as it then exists I hope to be able to have another look at this proposition next year with a view to some movement. I do trust that this olive branch will be accepted, and that I am not forced in subsequent debate to erect defensive battlements. This can be done, but I would like to avoid the necessity, which indeed I think could be counterproductive.

110. The cost to the revenue of my tax concessions is $1.37 billion, and the estimate of total revenue thus becomes $37.8 billion. The difference between this and the estimate of total expenditure of $35.5 billion is $2.3 billion, which is the surplus we are budgetting for on General Revenue Account in 1982-83.[13]

111. These concessions produce satisfactory results as far as the balance of the fiscal system[14] and the budgetary guidelines are concerned.[15]

112. But I must again draw attention particularly to the growth and relative size of the public sector in 1982-83. On Consolidated Account total expenditure will be no less than $37.7 billion. This is an increase in money terms of $6.8 billion, or 22% over the revised estimate for 1981-82. In real terms it represents an increase of 10.7%. The growth rate of 10.7% envisaged for 1982-83 though large thus represents a significant slowing down in the growth rate of the public sector, but it will still be higher than the forecast growth rate of G.D.P. of 8%.

113. As a result, the relative size of the public sector will again increase from 22.9% in 1981-82 to about 24% in 1982-83. We clearly must not relax in our efforts to ensure that the growth rate of expenditure on Consolidated Account has due regard to the growth rate of the economy.

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12. "Is there really any valid reason why one family with an income of, say, $100,000 should pay less tax than another family with a similar income, simply because in the first case the $100,000 is produced by the husband and wife, whereas in the second case the husband (or wife) alone contributes to the support of the family."

13.

Revenue:	*$mn*	*$mn*
Recurrent	25,308	
Capital	12,518	37,826
Expenditure:		
Recurrent	19,466	
Capital	16,034	35,500
Surplus on recurrent account		5,842
Deficit on capital account		3,516
Overall surplus		2,326

(Including the surplus in the C.W.R.F. the total overall surplus is $4,954 million).

14. Ratio between direct and indirect taxes – 67 : 33.

Ratio between direct and indirect taxes taken together and all other recurrent revenue – 66 : 34.

15.

Guideline	*Ratio*	*1982-83*
Recurrent revenue / Total expenditure	At least 77%	77%
Recurrent expenditure / Recurrent revenue	No more than 85%	77%
Surplus on recurrent account / Capital expenditure	At least 33%	44%
Recurrent expenditure / Total expenditure	No more than 65%	59%
Capital revenue / Capital expenditure	At least 20%	93%

(The percentages for 1982-83 are calculated to include the Capital Works Reserve Fund.)

IFA NEWS

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JAPANESE BRANCH

The Japanese Branch held its 1982 annual conference in Tokyo on 1 May 1982.

At the conference, the following subjects were reported on:

(1) Recent Trends of Japanese Tax Treaties, by Mr. Yasuyuki Kawahara, Director of the International Tax Affairs Division, Tax Bureau, Ministry of Finance.

(2) Aussensteuergesetz of West Germany, by Professor Tadashi Murai, Professor of Law, Kansai University.

(3) Unitary Tax in the United States of America, by Mr. Toshio Miyatake, attorney-at-law.

SWISS BRANCH

The Swiss Branch of IFA will meet on 25 June 1982 in Zurich. The agenda shows the following important topics of discussion:

1. The presenting of the 1981 annual report and the 1981 financial statements;
2. The resignation of a number of members of the Board and the Board's proposal for the (re)appointing of (new) Board members;
3. Dr. Vögeli will speak on the tax aspects of international competition with respect to Swiss banks.

The next meeting of the Swiss Branch will be held on 5 November 1982 in Bern.

Customs Co-operation Council *

Since the beginning of the century, attempts have been made to simplify and standardize Customs formalities in international trade. The first substantial proposals for simplification were sponsored by International Congresses of European Trades and brought forward by the International Chamber of Commerce for consideration by the League of Nations. Inter-governmental actions taken under the aegis of the League resulted in the drafting of the international Convention for the simplification of Customs and other formalties. This Convention, dated 3 November 1923, was the first concrete result obtained.

Several subsequent international conferences also studied this question but achieved no appreciable results.

After the end of the second World War the United Nations Conference on Trade and Labour resumed the examination of the problem at international level. Several provisions relating to Customs questions were included in the draft for the establishment of an International Trade Organization (Havana Charter) and in the "General Agreement on Tariffs and Trade" (GATT).

Nevertheless, there was still no international organization specializing in the comparative study of Customs technique, which was regarded merely as an aspect of economic policy and had been given close consideration only at national level and in very few countries.

THE EUROPEAN CUSTOMS UNION STUDY GROUP:

In a joint declaration made in Paris on 12 September, 1947, thirteen Governments represented on the Committee for European Economic Co-operation agreed to give consideration to the possibility of establishing one or more European Customs Unions. With this end in view, it was decided to set up in Brussels a Study Group to examine the problems incidental to the project and the steps necessary for its materialization.

In 1948, this Study Group set up an Economic Committee and a Customs Committee, the latter being assisted by a Permanent Tariff Bureau.

The Study Group subsequently suspended the activities of the Economic Committee, the work of which was tending to overlap with that of the Organization for European Economic Co-operation (OEEC) after the creation of that organization.

It was decided, however, that the Customs Committee, which had been charged with the task of making a comparative study of Customs techniques in the various countries concerned, with a view to their standardization, should pursue this work. This Committee devoted particular attention to the establishment of a common tariff nomenclature and the adoption of a common definition of value for Customs purposes. It also studied other aspects of Customs procedures.

THE CONVENTIONS OF 15TH DECEMBER 1950:

In 1949, the Study Group decided that, irrespective of the progress which might be made with the Customs Union project, the achievements already attained in the fields of Nomenclature and Valuation should be turned to advantage and that similar endeavours should be made in other fields of Customs technique.

This decision was the origin of the three Conventions signed in Brussels on 15th December 1950. Two of these Conventions are concerned with Nomenclature and with Valuation; they represent the culmination of the extensive work undertaken by the Study Group's Customs Committee on these two important subjects. The purpose of the participating countries in setting up – under the third Convention – the Customs Co-operation Council was not only to assemble the executive machinery required for the interpretation and application of the two specialized Conventions in a single international organization but also to entrust that organization with a more general responsibility: "to secure the highest degree of harmony and uniformity in Customs systems and especially to study the problems inherent in the development and improvement of Customs technique and Customs legislation in connection therewith."

ESTABLISHMENT OF THE CUSTOMS CO-OPERATION COUNCIL:

The Convention establishing a Customs Co-operation Council came into force on 4 November 1952, and the Council met for the first time on 26 January 1953. Under the provisions of this Convention, the Customs Co-operation Council is required to:

- make recommendations to ensure the uniform interpretation and application of the two other Conventions (on Nomenclature and Valuation);
- perform such functions as may be expressly assigned to it in those Conventions; and
- act in a conciliatory capacity in any disputes which may arise in this respect.

Apart from these particular functions, the Council has the more general task of:

- studying all questions relating to co-operation in Customs matters which the Contracting Parties agree to promote;
- examining the technical aspects of Customs systems with a view to proposing practical means of attaining the highest possible degree of harmony and uniformity;
- preparing for this purpose draft Conventions and Recommendations;
- circulating information regarding Customs procedures;
- furnishing information or advice to Member States; and
- co-operating with other international organizations.

In order to enable the Council to accomplish this extensive task, Articles V and VI of the Convention provide that it shall establish the two specialized Committees envisaged by the Nomenclature and Valuation Conventions and shall be assisted by a Permanent Technical Committee, in respect of other Customs matters, and by a General Secretariat.

The functions of the Council are thus clearly defined. They in no way duplicate the activities of other international organizations particularly of those essentially concerned with economic policy.

The Council is a technical body and its studies and attempts to resolve Customs problems are based on a purely technical approach. Its purpose is to improve and harmonize Customs operations and thus facilitate the development of international trade, without obliging Member countries to adopt provisions incompatible with their individual economic policies.

Accession to the Council Convention dopes not entail accession to either or both of the two other Conventions on Nomenclature and Valuation, but accession to the Council Convention is obligatory for any country wishing to accede to either of those Conventions.

THE COUNCIL AT WORK:

The Council normally meets once a year. The delegates to the Council are representatives of the Contracting Parties to the Council Convention and those representatives are usually the heads of national Customs administrations.

* Prepared by Douanes (Pakistan) Custom House, Karachi.

The first part of each Session is devoted to technical matters. The Council receives reports from the Nomenclature Committee, from the Valuation Committee, from the Permanent Technical Committee, the Harmonized System Committee and, on intersessional developments, from the Secretary General. After discussion of these reports, the Council takes such executive decisions as may be appropriate, for example, by initiating Conventions or Protocols of amendment to Conventions, by making Recommendations to Contracting Parties, and by giving directives to the Committees or to the Secretary General regarding the work in progress or future work to be undertaken.

One or two days at the end of each Session are reserved for current administrative and internal questions which are usually presented in the form of proposals worked out in advance either by the Finance Committee – which meets before each Council Session – or by the Secretary General.

The adoption of these methods enables the work of each Session to be conducted expeditiously.

The official languages of the council are English and French and all documents and publications are issued in these two languages.

THE NOMENCLATURE COMMITTEE:

Under the authority of the Customs Co-operation Council, the Nomenclature Committee supervises the operation of the Convention on Nomenclature for the Classification of Goods in Customs Tariffs.

This Convention, which entered into force on 11 September 1959, has been ratified by several countries. In addition, many countries or territories have based their national tariffs on the Customs Co-operation Council Nomenclature (CCCN), without becoming Contracting Parties to the Convention.

The CCCN is also used by many regional organizations, including the European Communities, the European Free Trade Association (EFTA), the Latin American Free Trade Association (LAFTA), the Common Afro-Mauritian Organization (OCAM), the West African Economic Community (CEAO) and the Central African Customs and Economc Union (UDEAC).

AIMS OF THE NOMENCLATURE CONVENTION:

The essential aims of the Nomenclature Convention are:

(a) to establish a common basis for the classification of goods in national Customs tariffs;
(b) to facilitate comparison of the Customs duties applicable in various countries to all goods entering into international commerce;
(c) to simplify international Customs tariff negotiations;
(d) to facilitate comparison of international trade statistics;
(e) to provide Government and traders alike with a firm guarantee of the maximum uniformity in the classification of goods in national Customs tariffs; and
(f) to facilitate international trade and thus to contribute to its expansion.

CHARACTERISTIC FEATURES OF THE CCC NOMENCLATURE:

The CCCN is systematic. It provides a framework for the classification of goods in Customs tariffs but, since it includes Interpretative Rules and legal Notes, it also constitutes a comprehensive classification system which has been designed to ensure:

(a) maximum simplicity, so that it can be readily understood by the public as well as by experts;
(b) precision, so that the most appropriate heading for a given commodity can be readily identified; and
(c) exactness in application, so that the same commodity will be classified in the same way in the tariffs of the countries using the Nomenclature.

STRUCTURE OF THE CCC NOMENCLATURE:

The CCCN comprises:

(a) the Rules for the interpretation of the Nomenclature which prescribe the general principles governing the classification system;
(b) Section and Chapter Notes, which define the scope and limits of Sections, Chapters and of certain headings. These legal Notes permit the headings to be drafted in concise form without any loss of precision or of exactitude in their interpretation; and
(c) a list of headings, arranged in systematic order, covering all the times in international commerce.

The headings in the Nomenclature are arranged in 99 Chapters which are themselves grouped in 21 Sections. In general, goods are grouped according to the material of which they are made; further, most Chapters are developed "progressively" – that is, starting from raw materials and progressing to finished articles.

ADAPTATION OF THE CCC NOMENCLATURE TO THE ECONOMIC REQUIREMENTS OF INDIVIDUAL STATES:

The Nomenclature Convention leaves the Contracting Parties free, within the framework of the Nomenclature, to make such provisions as they may consider necessary in order to safeguard their own special national interests.

In particular, countries may set up, within the CCCN headings, subheadings covering those products or categories of products to which they propose to apply special treatment. They also remain perfectly free to fix their rates of duty at the levels they consider appropriate, subject to due regard to any bilateral or multilateral commitments they may have entered into with other countries.

SUPPORTING PUBLICATIONS:

The CCCN is supported by several publications designed to facilitate its use and interpretation.

The Explanatory Notes do not form an integral part of the Nomenclature Convention itself, but they do constitute the official interpretation of the Nomenclature as approved by the Council and they are, therefore, an indispensable complementary publication thereto.

In addition to technical information, the four volumes of the Explanatory Notes provide a full commentary on the meaning and scope of the Section and Chapter Notes and on the scope of each heading.

The Alphabetical Index to the Nomenclature and the Explanatory Notes lists all the goods specified in the Nomenclature, with references to the relevant headings or Section or Chapter Notes, and in the Explanatory Notes, with reference to the pages on which the goods are mentioned and, in some cases, described.

The Compendium of Classification Opinions lists, in Nomenclature heading order, all Classification Opinions adopted by the Nomenclature Committee and the Customs Co-operation Council as a result of the study of practical cases submitted to the Council by the administrations.

The English and French versions of the Nomenclature and its complementary publications are equally authentic. They are kept constantly up-to-date, in particular in the light of current technological developments.

THE NOMENCLATURE COMMITTEE AT WORK:

The Nomenclature Committee met for the first time on 23 May 1960, after the entry into force of the Convention, but the Council had set up an Interim Committee from early 1953 and in effect the Committee has been at work since then.

The Committee normally meets twice a year for a fortnight at a time. It is composed of delegates representing Contracting Parties to the Convention. Its Sessions are attended by Observers from many non-Member States and from International Organizations. The Committee is assisted by a Committee of Chemists which also meets, in principle, twice a year.

The Nomenclature Committee's main tasks are to give decisions on the more declicate classification questions raised by administrations or by International Organizations, to resolve differences of opinion between Customs administrations and, in general, to take all appropriate steps to ensure international uniformity in the interpretation and application of the Nomenclature.

To this end, the Committee:

(a) collates and circulates information concerning the application of the Nomenclature;
(b) studies the procedures and practices of the Contracting Parties in relation to the Classification of goods for Customs purposes;
(c) makes appropriate recommendations to the Contracting Parties to secure uniformity in the interpretation and application of the Nomenclature;
(d) prepares draft amendments to the Nomenclature Convention;
(e) drafts and amends the Explanatory Notes;
(f) issues Classification Opinions; and
(g) takes such other steps as may be necessary to achieve the aims set by the Convention establishing the Customs Co-operation Council and the Convention on Nomenclature.

AMENDMENTS TO THE NOMENCLATURE:

Since 1959 the CCC Nomenclature has undergone three series of amendments, in 1965, 1972 and 1978, in order to keep it abreast of developments in the fields of production and international trade.

The third series of amendments, published in the Recommendation of 18 June 1976, entered into force on 1 January 1978. It includes more than 260 amendments to the 1972 Nomenclature, the main changes being the deletion of some 90 headings which no longer represented a significant volume of international trade and the amendment or creation of other headings.

THE CCN AND INTERNATIONAL TRADE STATISTICS:

It has already been mentioned that one of the aims of the CCCN is also to facilitate comparison of international trade statistics, insofar as these are compiled from data collected on the basis of the national Customs nomenclatures.

In 1950, the United Nation Statistics Office established a Standard International Trade Classification (SITC), to facilitate the systematic study of world trade statistics.

Since the aims in a single area of activity were very much akin, it was necessary to establish a close correlation between the two basic systems of classification.

The first correlation between the CCC Nomenclature and the revised SITC was completed in 1960. A new correlation was concluded in 1974, when the SITC was revised for a second time (SITC/Rev. 2).

The SITC/Rev. 2 was published on 1 January 1975. On the same date, the Council issued a Recommendation proposing that Member States incorporate in their Customs tariffs the 1,087 subheadings which make it possible to collect statistical data on the basis of the CCC Nomenclature and to achieve complete correlation with the SITC/Rev. 2. The complete system (SITC/ Rev. 2 and the new correlation) entered into application in a number of countries on 1 January 1976.

THE FUTURE OF THE CCC NOMENCLATURE:

The future of the Nomenclature is bound up with the work on the Harmonized Commodity Description and Coding System.

THE HARMONIZED SYSTEM COMMITTEE:

In September 1970 the Council set up a Commodity Coding Study Group to explore the feasibility of developing a harmonized commodity description and coding system which could simultaneously meet the needs of Customs, external trade statistics and carriers.

This Study Group reported to the Council in May 1973 that the development of a harmonized commodity description and coding system was not only feasible but was essential in the longer term interests of facilitation on international trade and recommendaded that the Council undertake to carry the project to completion. The Council approved the Study Group's Report, and decided that such a system should be developed.

In preparing the system, the Harmonized System Committee, which was created by the Council to succeed the Study Group, is taking account of some 15 classification systems, chosen as being representative of the requirements of Customs administrations, external trade statistics and carriers.

The system is based on the CCCN and on the SITC/Rev. 2 which will be revised where necessary to achieve the system's general aims.

In some respects, therefore, the Harmonized System will be a development of the revised CCCN elaborated by the introduction of subheadings (structured nomenclature), which will include those already drawn up for the correlation between the CCCN and the SITC/ Rev. 2.

The system also includes "descriptors" for the more important commodities in international trade. These descriptors will provide cross-references to the subdivisions of the structured nomenclature and the SITC/Rev. 2 and will also serve for the compilation of an alphabetical index.

Implementation of the system will be facilitated by Explanatory Notes which will supplement those of the CCCN by providing a guide to classification in the subheadings, and it is hoped that the system will eventually be employed by most, if not all, participants in international trade.

The concern for the harmonization and simplification of the various national and international instruments used in international trade, which brought about the development of the Harmonized System, is felt by many agencies. In particular, the United Nations Statistical Commission, at its 19th Session (November 1976), agreed that the Harmonized System should also play a prominent part in the harmonization of the various statistical classifications concerning transportable goods.

This will be possible if the CCCN and its extension, the Harmonized System, are compatible with the concept of the industrial origin of commodities, and this principle has been approved by the Council.

THE VALUATION COMMITTEE:

Under the authority and in accordance with the directives of the Council, the Valuation Committee supervises the operation of the Convention on the Valuation of Goods for Customs purposes. This Convention entered into force on 28th July 1953. Since then the Brussels Definition of Value which is annexed to the Convention has found a steadily widening field of application. Apart from the Contracting Parties to the Convention many countries have already based their valuation systems for Custom purposes on the Definition.

AIMS OF THE VALUATION CONVENTION:

The essential aims of the Valuation Convention are:

(a) to achieve the maximum uniformity, internationally, in the valuation of goods for Customs purposes;
(b) to simplify international Customs tariff negotiations and the comparison of foreign trade statistics by providing a uniform basis for the valuation of goods; and
(c) in general, to facilitate international trade.

CHARACTERISTIC FEATURES OF THE BRUSSELS DEFINITION OF VALUE:

The Brussels Definition of Value is designed to:

(a) provide for the establishment of Customs values by reference to a single formula to be uniformly applied to all clas-

ses of importations, thus ensuring equitable treatment as between all imported goods;
(b) conform as closely as possible to commercial practice in open market conditions;
(c) ensure that administrations are safeguarded against evasion;
(d) ensure that honest traders are protected against unfair competition and arbitrary administration; and
(e) meet the needs for commercial simplicity and administrative convenience.

These requirements are met by:
(a) selecting the standard of the price made under a contract of sale concluded:
    (i) in respect of imported goods, and
    (ii) in the open market between a buyer and a seller independent of each other;
(b) giving precision to this standard by specifying the contract of sale to be a contract concluded at a price:
    (i) appropriate to the time when the duty becomes payable, and
    (ii) giving delivery to the buyer at the port.
(c) setting up this standard in the Definition as a notional concept expressed in terms of the price which the goods "would fetch" on a sale conforming, inter alia, to the conditions envisaged at (a)(i), (a)(ii), (b)(i) and (b)(ii) above.

THE VALUATION COMMITTEE AT WORK:

The Valuation Committee normally meets twice a year. It is composed of delegates representing Contracting Parties to the Convention. Its Sessions are attended by Observers from many non-Member States and from International Organizations.

Its task, in general, is to ensure the uniform interpretation and application of the Definition.

To this end the Committee's duties are:
(a) to collate and circulate information concerning the valuation of goods by the Contracting Parties;
(b) to study the domestic laws, procedures and practices of Contracting Parties in relation to the Definition and its Interpretative Notes and to make recommendations to the Council or the Contracting Parties to secure uniformity in the interpretation and application of the Definition and Notes and the adoption of standard procedures and practices;
(c) on its own initiative or on request, to furnish to Contracting Parties information or advice on any maters concerning the valuation of goods;
(d) to submit to the Council proposals for any amendment of the Convention which it may consider desirable; and
(e) to exercise such other powers and functions of the Council in relation to the valuation of goods for Customs purposes as the Council may delegate to it.

RECOMMENDATIONS:

The Valuation Committee has established the following Recommendations:
- Recommendation concerning the treatment of inadvertent errors in the declared value of goods;
- Recommendation concerning the treatment, in the valuation of goods, of the right of reproduction in the country of importation;
- Recommendation concerning the application of the Brussels Definition of Value;
- Recommendation concerning the application of the provisions of Article III of the Definition of Value and of its Interpretative Note 2;
- Recommendation concerning the application of the Definition of Value in regard to trade marks; and Recommendation concerning the interpretation of Article I of the Definition of Value.

EXPLANATORY NOTES:

One of the important tasks completed by the Committee has been the preparation of the Explanatory Notes to the Definition, which were first published in 1960. Further experience gained since 1960 having shown that some revision of, and additions to, the Explanatory Notes were desirable, a new edition was issued in 1971 in three separate volumes (one English, one French and one bilingual).

These Explanatory Notes, which are available to the public as well as to the Customs, expound the theory and practice of valuation under the Brussels Definition both in general terms and with regard to problems of a general nature and, within these generalities, also with regard to particular problems of common occurrence. They give reasons for each conclusion and demonstrate the underlying equality of treatment as between the different methods advocated. As it has been put shortly, they provide the "Why" as well as the "How" of valuation.

Although these Notes do not form part of the Valuation Convention, they constitute the official Commentary on the Brussels Definition of Value.

EXAMPLES TO ILLUSTRATE SELECTED PASSAGES IN THE EXPLANATORY NOTES:

In order to facilitate the practical application of the Explanatory Notes referred to above, the Committee decided to supplement them by suitable Examples indicating how the text they illustrate should be applied to factual cases.

Two loose-leaf volumes, one in English and one in French, containing 34 such Examples were published in 1975, and further Examples are being added as they are prepared and adopted by the Committee.

VALUATION OPINIONS:

In pursuing the general aim of ensuring uniformity in interpretation and application of the Definition, the Committee has issued several Valuation Opinions based on actual cases of doubt submitted by Members.

VALUATION NOTES:

The foregong aim is also achieved by means of a number of Valuation Notes which serve the purpose of clarifying the meaning of certain terms of the Definition which present difficulties in interpretation.

VALUATION STUDIES:

The Committee has made studies on a number of important aspects of valuation, such as Members' domestic legislation; administrative procedures; valuation disputes; the combating of fraud; the treatment of royalties; expenses incurred on advertising and trade marks; the dutiable value of computers and programme media; and the application of the Recommendation concerning the right of reproduction.

Certain of these studies have been published.

COMPENDIUM OF TEXTS CONCERNING VALUATION:

The Valuation Convention, Recommendations, Opinions, Notes and Studies are published together in a Compendium.

THE PERMANENT TECHNICAL COMMITTEE:

As mentioned previously, the Council's functions include not only ensuring the uniform interpretation and application of the Conventions on Nomenclature and Valuation but also the study of all aspects of Customs technique in order to find practical means of attaining the highest possible degree of harmony and uniformity in Customs systems. It is assisted in this latter work by the Permanent Technical Committee.

This Committee, which was established in 1953, is composed of representatives of all Council Members. It meets twice a year and its sessions are attended by both representatives of Member countries and by observers from many non-Member countries and international organizations.

The achievement of a high degree of harmony and uniformity is a long-term project. In this connection a wide-embracing international instrument, the Convention on the simplification and harmonization of Customs procedures is now in force. A number of other Conventions and Recommendations have been prepared on specific subject matters of Customs technique.

Another matter which has occupied the Committee's attention is that of mutual administrative assistance between Customs administrations for the prevention, investigation and repression of Customs offences. The Committee prepared a Recommendation on this topic as early as 1953 and followed up with additional Recommendations in 1971 and 1975. In 1977 the Council adopted a major instrument n this field, the International Convention on mutual administrative assistance for the prevention of Customs offences. Particular emphasis has always been placed on the combating of illicit traffic in narcotic drugs and psychotropic substances.

In addition to technical Conventions and Recommendations, the Permanent Technical Committee has carried out a systematic study of procedures in Member countries on the basis of which International Customs Norms have been drawn up laying down fundamental principles to guide Customs administrations considering amendment or review of Customs legislations or regulations. The Committee has also prepared a Glossary at present containing some 60 terms with definitions in English and French, and which, when complete, will result in a uniform international Customs terminology. The Glossary will be brought up-to-date as required.

In parallel with these activities, the Committee devotes part of each session to the consideration of such maters as the simplification of documentation, postal traffic, and also to questions submitted by Members or by international organizations. These latter, according to circumstances, are either discussed by the Committee or are circulated to Members as requests for information or for written observations.

A Working Party has been established to deal with the practical applications of computers in the Customs field.

CUSTOMS CONVENTIONS:

The Committee has produced eleven Conventions which are open to all Council Members and in most cases to all Members of the United Nations or its specialized agencies.

1. International Convention on the simplification and harmonization of Customs procedures

This Convention, adopted by the Council on 18 May 1973, deals systematically with all the principal Customs rules and procedures. It consists of a central body and separate Annexes, each of which lays down the basic principles applicable to a distinct area of Customs activity. It is anticipated that ultimately the Convention will have some 30 Annexes. The 20 Annexes adopted so far deal with subjects such as Customs warehouses, drawback, temporary admission subject to re-exportation in the same state, clearance for home use, Customs transit, rules of origin, repayment of import duties and taxes, free zones, Customs facilities applicable to travellers, outright exportation and postal traffic.

2. Conventions concerning temporary duty-free importation

(a) The Customs Convention of 6 October 1960 on the Temporary Importation of Packings (entered into force on 15 March 1962).

This Convention meets a wish frequently expressed by representatives of international trade for the extension of temporary duty-free importation procedures to packings. The Contracting Parties undertake to grant temporary admission to packings, subject to the conditions specified in the Convention, and to accept an undertaking to re-export the packings in lieu of security whever the Customs authorities deem this possible.

(b) The Customs Convention of 8 June 1961 on the Temporary Importation of Professional Equipment (entered into force on 1st July 1962).

This Convention is designed to facilitate the international exchange of specialised skills and techniques by the introduction of general rules on the temporary duty-free importation of professional equipment.

It has three Annexes, one relating to equipment for the press or for sound or television broadcasting, one to cinematographic equipment and the third to other professional equipment.

(c) The Customs Convention of 8 June 1961 concerning Customs facilities for the Importation of Goods for display or use at Exhibitions, Fairs, Meetings or Similar Events (entered into force on 13 July 1962).

The purpose of this Convention is to facilitate the display of goods at exhibitions, fairs, meetings or similar events of a commercial, technical, religious, educational, scientific, cultural or charitable nature.

It deals, in particular, with:
- the temporary admission of goods and equipment for display or use at an event;
- the waiving of import duties in respect of certain goods (small samples, printed matter, catalogues, etc.); and
- the simplification of formalities on importation and re-exportation.

(d) The Customs Convention of 1st December 1964 concerning Welfare Material for Seafarers (entered into force on 11 December 1965).

This Convention was drawn up by the Council on the initiative of and in consultation with the International Labour Organization. Its aim is to promote the welfare of seafarers on ships engaged in international maritime traffic.

Contracting Parties undertake to grant facilities in respect of welfare material for use on board foreign ships and, unless a reservation is entered in this respect, to welfare material for use in welfare establishment ashore.

(e) The Customs Convention of 11 June 1968 on the Temporary Importation of Scientific Equipment (entered into force on 5 September 1969).

This Convention helps to materialize the principle of the "free flow of ideas" which has been advocated and promoted by UNESCO for more than twenty years. It removes certain difficulties encountered in the implementation of the 1950 Florence Agreement and supplements, with regard to scientific equipment, the Professional Equipment Convention and the Fairs and Exhibitions Convention which were also drawn up by the Council in co-operation with UNESCO.

The Contracting Parties undertake to grant temporary admission, free of duties and taxes, to instruments, apparatus, mahines or accessories therefor which are to be used for purposes of scientific research or education by "approved institutions" and to reduce the attendant Customs formalities.

(f) The Customs Convention of 8 July 1970 on the Temporary Importation of Pedagogic Material (entered into force on 10 September 1971).

This Convention is designed primarily to supplement, in the field of educational materials, the Scientific Equipment Convention. It rounds off the work done by the Council, in co-operation with UNESCO, in connection with the temporary importation of educational, scientific and cultural materials.

Under the Convention the Contracting Parties undertake to grant and facilitate the temporary admission, free of import duties and taxes, of pedagogic material which complies with the prescribed conditions (and with certain optional conditions which may be imposed by each Contracting Party). A non-limitative list of pedagogic material is annexed to and forms an integral part of the Convention.

3. Conventions introducing international Customs documents:

(a) The Customs Convention of 1st March 1956, regarding ECS Carnets for Commercial Samples (entered into force on 3rd October 1957).

The aim of the Convention was to facilitate the temporary duty-free importation of commercial samples.

(b) In view of the success of the ECS carnet, in 1961, the Permanent Technical Committee established the Customs Convention on the ATA carnet for the Temporary Admission of Goods. This carnet can be used not only for commercial samples but also for goods temporarily imported under:

- international conventions concerning temporary admission to which a State is party (e.g. Conventions on Professional Equipment, on Exhibitions, Fairs, etc.);
- national regulations on temporary admission.

The principle of the ATA Convention is the same as for the ECS scheme: it seeks to eliminate the two main difficulties encountered when importing goods temporarily into a country, namely the need to make out a Customs declaration on the national form each time the goods are taken into a country and the necesity of furnishing security for the payment of the Customs duties and other taxes chargeable in case of failure to re-export them.

This double aim is achieved by the ATA carnet which is an international Customs document issued and guaranteed by associations approved by the Customs and affiliated to an international chain.

Some years ago it was decided that the ATA carnet should replace the ECS carnet, in view of the latter's limited scope. This replacement has continued progressively and the point has now been reached when ECS carnets have practically disappeared. In the near future, therefore, there will be only one international document in use for temporary duty-free admission operations. In fact the Council has recommended to Contracting Parties to denounce the ECS Convention and a number of States have already done so.

4. Customs Convention on the international transit of goods (ITI Convention)

This Convention, adopted by the Council on 7 June 1971, was prepared to deal with emerging patterns in international traffic, particularly the widespread use of intermodal freight containers. The basic aim of the Convention is, whilst taking full account of the latest transport techniques, to provide the Customs with the possibility of carrying out their essential controls without creating transport delays, thus permitting transport operators to enjoy fully the advantages of the through-transport concept.

5. International Convention on mutual administrative assistance for the prevention, investigation and repression of Customs offices

The Convention applies to all Customs offences insofar as they involve matters falling within the competence of Customs administrations.

It is dividend into Annexes which can be accepted independently of each other. As is usual in mutual assistance instruments, the Convention is based on the principle of reciprocity, according to which a Contracting Party is required to give assistance to another Contracting Party only if both have accepted the Annexes concerned.

Annexes I to IX cover different aspects of mutual administrative assistance and apply to every kind of goods except those specified in Annexes X and XI, that is to say, narcotic drugs and phychotropic substances (Annex X) and works of art, antiques and other cultural property (Annex XI). It was felt advisable to prepare separate Annexes for these categories of goods because, for many countries, they represent a major problem which often cannot be handled within the usual framework and has aspects not normally associated with the more strictly fiscal or Customs type of offence.

RECOMMENDATIONS:

The Permanent Technical Committee has drawn up some thirty Recommendations, which can be grouped in the following categories:

(a) Recommendations designed to promote co-operation between Customs administrations.
For example:
- Pooling of information concerning Customs fraud.
- Spontaneous exchange of information concerning illicit traffic in narcotic drugs and psychotropic substances.

(b) Recommendations designed to secure uniformity in practice as regards duty-free admission or the repayment or remission of duties.
For example:
- Refund of import duties and taxes on shortages.
- Free admission of removable articles imported on transfer of residence.

(c) Recommentations to facilitate the international transport of goods, and travel and tourism.
For example:
- Simplified Customs control, based on the dual channel system, of passengers arriving by air, and by sea.
- Customs sealing systems in connection with the international transport of goods.

(d) Recommendations relating to the application of certain Conventions.
For example:
- Use of ATA carnets for commercial samples.
- Measures to facilitate the application of the ITI Convention.

(e) Recommendations to simplify and harmonize Customs documents.
For example:
- Lay-out key for Goods declaration (outwards).
- Adoption of a standard form of certificate of origin.

(f) Recommendation to ensure that adequate legal remedies are available to the tax-payer.
For example:
- Right of appeal in Customs matters.

PUBLICATIONS CONCERNING CUSTOMS TECHNIQUE:

A compendium containing the texts of the Recommendations, Resolutions and International Customs Norms relating to Customs technique has been published. It is intended to incorporate the Glossary of international Customs terms in this Compendium in due course.

A Handbook containing the complete texts of the international Convention on the simplification and harmonization of Customs procedures and its Annexes, with a Commentary printed after the relevant provisions, has also been published. The detailed information furnished by Contracting Parties with regard to the implementation of Annexes and other matters (reservations, terms of application, etc.) is also included.

RELATIONS WITH OTHER INTERNATIONAL ORGANIZATIONS:

Under the terms of the Convention by which it was established, one of the Council's functions is to co-operate with other inter-governmental organizations and maintain with them such relations as may facilitate the achievement of its aims. It also co-operates with certain non-governmental organizations dealing with questions within its competence.

Over the years the Council has established close relations with a large number of organizations, either directly or through its Committees or the Secretariat, exchanging observers or co-operating even more directly in the study of questions mutually of concern to those organizations and the Council.

TECHNICAL CO-OPERATION:

The Council has rendered technical assistance in various spheres of Customs work to a large number of Member and non-Member developing countries.

Many countries have been given assistance in transposing their tariffs into the form of the CCC Nomenclature, such being a prime necessity for any country wishing to modernize and rationalize its Customs procedures. Also of great importance is the adoption by countries of the Brussels Definition of Value and a number of countries have been helped in this respect. Further, countries have been advised on means of implementing the wide range of other instruments which have been devised by the Council to improve Customs efficiency and to facilitate international trade. In many instances it has been possible to arrange for "on-the-spot" assistance by experts, the selection of the experts being made in co-operation with Member countries of the Council and other international organizations, particularly the United Nations, the United Nations Conference on Trade and Development, the United Nations Development Programme, the International Monetary Fund, the Organization of American States, the United Nations Sttistical Office and the United Nations Regional Economic Commissions.

Considering the importance of training with a view to the establishment of an efficient Customs administration, the Council has published a brochure entitled "Training Facilities for Customs Officials of Developing Countries" which contains full particulars of the training facilities available in Member countries. The facilities described in the brochure consist of participation in the normal training courses designed to meet the needs of some developing countries. Many trainees benefit from the facilities.

The Council also actively participates in the training programmes of other international organizations. It has provided lecturers from the staff of the Secretariat for training programmes of United Nations Regional Commissions and has organized courses in collaboration with the UNDP, UNCTAD and the OAS, some of the lecturers being Secretariat staff members and other being officials supplied by Council Members.

The Council's efforts in technical assistance, especially Customs training, are directed to complement the work being done bilaterally by its Member countries and to co-operate with other international and regional organizations.

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Tax Treaty Shopping

Art. 16 of the Draft U.S. Model Income Tax Treaty

By Michael J. Cooper and Thomas J. Rasmussen *

The purpose of this article is to comment on Article 16 of the draft U.S. Model Income Tax Treaty of 16 June 1981 (Model Treaty) and alternative versions of Article 16 in the Treasury News Release of 23 December 1981.[1]

I. COMMENTS ON U.S. TREATY POLICY

Treasury appears to have made a policy decision to include some form of Article 16 in all new U.S. income tax treaties in an attempt to prevent treaty shopping.[2] We recognize that there is a valid concern underlying such a policy. However, we believe that this policy would also discourage foreign investment in the United States and thus would not be helpful to the American economy. In the past, fostering such investment has been considered more important to the U.S. economy than trying to end all treaty shopping.[3]

Nevertheless, at a public meeting held at Treasury on 14 January 1982 to discuss Article 16, it was suggested that Treasury's policy decision on this matter would not be changed.

We are unaware of any economic studies that have been done by the Treasury which would justify this decision to overturn 42 years of U.S. treaty policy and administrative practice.[4] Therefor, we urge Treasury to re-consider this decision because we believe:

1. Article 16 could significantly reduce new foreign investment in the U.S.

2. Article 16 could cause a flight of already-invested foreign capital from the United States.

3. The effect could be to reduce the capital pool available to U.S. owned business for investment in new plant and equipment.

4. Concern about a possible flight of capital from the U.S. compelled Congress to make permanent in 1976 the temporary exemption from U.S. withholding tax on interest paid to non-resident aliens and foreign corporations on their U.S. bank deposits.[5]

If a serious outflow of foreign investment capital would have resulted from ending this exemption for interest, there can be no doubt that declining investment and a similar outflow will result from Article 16's elimination of reduced withholding tax rates on dividend and interest paid with respect to foreign portfolio investments in U.S. businesses.

5. Article 16 will discourage foreign investors from locating manufacturing plants, real estate projects, or other job-producing businesses in the United States. It is counter-productive for the U.S. to use Article 16 to try to collect more tax on dividends or interest when paid by such businesses to its foreign investors if Article 16 deters the business from being located in the U.S. in the first place.[6]

6. By discouraging foreign portfolio and foreign direct investment in the U.S., Article 16 may actually reduce U.S. income tax revenues from such investment in the U.S.

7. Article 16 could have a negative impact on U.S. tax revenues by preventing U.S. corporations from using the favorable treaty network of a U.S. treaty partner to lower the foreign income tax such corporations would otherwise have to pay to a third country. As a result, U.S. corporations (or their foreign subsidiaries) could pay more foreign income tax, which would produce higher foreign tax credits, and thus could further reduce U.S. income tax revenues.

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* . Deloitte Haskins & Sells.

1. The U.S. Model Income Tax Treaty serves as the starting point for U.S. negotiators in negotiating an income tax treaty with a foreign country.

2. Treaty shopping involves residents of countries that do not have an income tax treaty with the U.S. (third countries) or that have less favorable income tax treaties with the U.S. These third-country residents organize a corporation in a country that has a favorable treaty. They then use the treaty-country corporation to invest in the U.S. Because of the treaty, the treaty-country corporation receives reduced rates of withholding on any U.S. dividends, interest, rentals and royalties derived from that investment.

3. See, e.g.: Rev. Rul. 75-23, 1975-1 C.B. 290.

4. The only possible exception to this policy is the U.S.–Netherlands Income Tax Treaty, as it applies to the Netherlands Antilles. See: Statement of Treasury Department With Respect to the Protocol of 23 October 1963, in II P-H Tax Treaties: Netherlands 66,169 (1982).

5. See: section 861(a)(1)(A) and (c). The General Explanation of the TRA of 1976, prepared by Staff of Jt. Comm. on Tax., 94th Cong., 2d Sess. 256 (1976), states that

> Congress has concluded that the elimination of the exemption would result in a *significant decline* in the substantial deposits by non-resident aliens and foreign corporations in banks in the United States. Since *a possible shortage of investment capital* presently exists in the United States, Congress concluded further that *it would not be advisable at this time to permit the exemption to expire at the end of 1976 with the resultant outflow in investment capital.*
>
> Moreover, it was decided to retain the exemption on a permanent basis. . . . [Emphasis added.]

6. The location of such businesses in the U.S. in recent years has been increasing. An important economic factor in locating these businesses in the U.S. instead of some competing location is the availability of a favorable bilateral U.S. income tax treaty. A favorable treaty is one that reduces the U.S. rate of withholding tax on U.S.-source dividends, interest, rents, and royalties. Typically, the foreign investor will organize a corporation in a country having a favorable treaty with the U.S. That corporation will then organize a U.S. corporation to which it contributes or loans large amounts of foreign capital to be used to run the U.S. business and hire American workers. The U.S. corporation will pay U.S. income tax on its profits. Because of the favorable income tax treaty, the U.S. will then pay dividends (from those previously taxed profits) and interest to its foreign parent corporation at reduced rates of U.S. withholding tax.

8. If included in revised U.S. tax treaties, Article 16 will render many existing foreign investments in the U.S. and U.S. investments in treaty countries economically unsound by denying the investors reduced rates of withholding tax. Many of these investments were made on the understanding that such reduced rates of withholding tax would be available.

9. The foreign portfolio investors that will be affected by Article 16 are, for the most part, not consuming U.S. social and governmental services. Consequently, the treaty benefits received by such third-country foreign investors are not unjustified in view of the capital they bring into the U.S.

10. We know of no authoritative economic studies done by Treasury on whether Article 16 will cause a revenue loss to the U.S., a loss in new foreign portfolio investment in the U.S., an outflow of already-invested foreign capital from the U.S., a reduction in the capital pool available to U.S.-owned business, or a reduction in the number of job-producing, foreign-owned businesses located in the U.S.
Therefore, we respectfully recommend that before any Article 16 policy is implemented, such studies be conducted to ensure that such a policy does not produce the investment and other losses discussed above.

II. TECHNICAL COMMENTS ON ARTICLE 16

These comments refer to the two basic versions of Article 16: the "June Draft", published as part of the proposed Model Treaty of 16 June 1981, and the "Discussion Draft", published in a Treasury News Release of 23 December 1981. These drafts currently exist as possible alternative formulations of Article 16 as it might appear in future U.S. income tax treaties.

75% Test (June Draft)

Article 16(1)(a) of the June Draft denies treaty benefits to a corporation of a contracting state unless "more than 75% of the beneficial interest" in the corporation is owned directly or indirectly by persons who are residents of that contracting state (hereinafter "75% test").[7]

This provision causes numerous problems:

Problem No. 1: The June Draft will discriminate against U.S. corporations that are foreign-owned, by denying them treaty benefits available to other U.S. corporations.

For example, suppose that a U.S. corporation, manufacturing automobiles in the U.S. and owned by Japanese residents, makes a loan to a Dutch affiliate. Suppose the 75% ownership test is included in the U.S.–Netherlands Income Tax Treaty. The U.S. corporation will lose its treaty exemption from Dutch withholding tax on interest received from the Dutch borrower, merely because the U.S. corporation is owned by non-residents of the U.S.

Article 16(1)(c) and (2)(e)(ii) of the Discussion Draft might cure this problem, but only if the income subject to treaty benefits is incidental to, or derived in connection with, the above corporation's U.S. business operations.[8] However, even if these tests are met, Article 16(2)(e)(ii) creates only a presumption that a foreign-owned U.S. corporation qualifies for the Treaty benefits. Because this presumption could be challenged by the subjective judgments of the revenue authorities of the other contracting state, it would be difficult to obtain certainty as to the application of this presumption. Moreover, the lack of a definition for the term "incidental" makes it difficult to judge when the presumption would operate in the case of income "incidental to" U.S. business operations.

We recommend that a definition of "incidental" be provided and that the presumption be made a conclusive one.

Article 16(1)(b), as supplemented by Article 16(2)(d) of the Discussion Draft, also might cure the problem in the June Draft, but only if more than 75% of the U.S. corporation is owned directly by resident individuals of a third-country having a U.S. income tax treaty (with relief not less favorable than, for example, the U.S.–Netherlands Treaty discussed above).[9] However, many U.S. corporations are directly owned by foreign corporations, not by foreign individuals. Thus, Article 16(2)(d) is not helpful in those cases.

Moreover, in the case of the Japanese-owned U.S. corporation discussed above, the U.S.–Japan Income Tax Treaty does not provide relief on interest payments as favorable as the U.S.–Netherlands Treaty. Even if it did, Article 16(2)(d) creates only a presumption, not a certainty, that the U.S. corporation qualifies for treaty benefits. We therefore recommend that the "presumption" language be deleted.

The "principal purpose test" in Article 16(2) of the June Draft might also resolve this problem, but again, this Article is too subjective.[10]

Problem No. 2: U.S. corporations are taxed on their world-wide income and thus can claim tax benefits

7. The term "contracting state" refers either to the U.S. or the foreign country with which the U.S. has concluded an income tax treaty.

8. Article 16(1)(c) of the Discussion Draft essentially provides that a corporation will be entitled to treaty benefits if it is established that the principal purpose of the corporation or of the conduct of its business was not to obtain such benefits (hereinafter "principal purpose test").
Article 16(2)(e)(ii) establishes the presumption that the principal purpose test is met if the income subject to treaty benefits is incidental to, or derived in connection with, the corporation's business operations in the contracting state of which it is a resident.

9. Article 16(1)(b) provides essentially that a corporation of a contracting state will be entitled to treaty benefits if it is controlled by residents of that state or U.S. citizens.
Article 16(2)(c) states that a person or persons shall be treated as having control of the corporation claiming treaty benefits if, under the income tax laws of the contracting state where income arises, they could be treated as having direct or indirect control of the corporation for any purpose.
Article 16(2)(d) presumes that the corporation meets this control test if (i) U.S. citizens, (ii) individual residents of the contracting state in which the above corporation is a resident, or (iii) individual residents of a third country having a U.S. income tax treaty (offering relief as favorable as the treaty in question) own directly more than 75% of such corporation. See Discussion below, pp. 294-295.

10. Article 16(2) of the June Draft allows treaty benefits to a corporation if it is determined that the acquisition or maintenance of the corporation and the conduct of its operations did not have as a "principal purpose" obtaining benefits under the treaty. See Discussion below, pp. xxx-xxx, for a more complete treatment of this Article.

granted by the Code without regard to whether any shares are owned by U.S. residents.[11]

Since the U.S. taxes on the basis of world-wide income without regard to the identity of the shareholders, access to our treaty system should be allowed on an equal basis, regardless of ownership.

Problem No. 3: The 75% ownership test is too high.

If a corporation resident in a contracting state is not a sham and has a good business purpose, apart from the U.S. treaty benefit, for residing there, the fact that less than 75% of its shareholders are non-residents should be irrelevant to its access to treaty benefits.[12]

As just noted, a U.S. corporation is considered to be sufficiently connected to the U.S. for all purposes of the Code, even if none of its shares are owned by U.S. residents and none of its income is derived from the U.S.[13]

In adopting Subpart F and the foreign personal holding company (FPHC) provisions. Congress thought that if U.S. persons owned more than 50% of a foreign corporation, that corporation was sufficiently connected to the U.S. for its income, on a pro rata basis, to be subject to the U.S. taxing jurisdiction.

If more than 50% U.S. ownership is needed for Subpart F and FPHC purposes, and no U.S. ownership is necessary to tax a foreign-owned U.S corporation, a requirement that more than 75% U.S. ownership is necessary to claim treaty benefits is too high.

Problem No. 4: An international finance subsidiary (IFS) is an important vehicle for raising foreign capital for U.S. businesses. The 75% ownership test in the June Draft undercuts the economic viability of an IFS created by a U.S. corporation in, for example, the Netherlands Antilles by denying treaty benefits to that IFS. The reason is that, typically, more than 75% of the beneficial interest in such an IFS is owned by U.S. corporations that are not residents of the Netherlands Antilles.

This problem in the June Draft appears to be cured by Article 16(2)(e)(ii) of the Discussion Draft if the U.S.-source interest income received by the IFS for which the Antilles treaty benefit is claimed can be regarded as derived in connection with, or incidental to, the conduct of business operations by the IFS in the Netherlands Antilles.[14] Thus, we recommend that such income be regarded as derived in, or incidental to, the conduct of such business operations so that this presumption would clearly apply.

If not cured by Article 16(2)(e)(ii), this problem is also not cured by the control test in Article 16(1)(b) or (2)(d)(i) of the Discussion Draft, unless "citizens of the United States" can be interpreted to be the U.S. corporate owners of the IFS, an unlikely interpretation.[15]

Problem No. 5: For the same reasons, the 75% test in the June Draft denies treaty benefits to, and thus undercuts the economic viability of, an IFS created, for example, in the Netherlands by a Canadian corporation to raise funds to loan to its U.S. operating companies.

Interest paid by those U.S. companies to the IFS (because the IFS is Canadian-owned) would lose the exemption from U.S. withholding tax afforded by Article 8 of the U.S.–Netherlands Treaty if the 75% test were included in that treaty.

Article 16(2)(d)(iii) of the Discussion Draft may prevent this problem but only in cases where the shareholders of the IFS are individual residents of countries having income tax treaties with the U.S. and those treaties grant relief as favorable as the relief claimed under the Netherlands Treaty.[16]

The present U.S.–Canada Treaty does not grant relief as favorable as the the Netherlands Treaty.[17] Also, shareholders of an IFS are ordinarily not individuals

Stock Trading and the 75% Test (June Draft)

For purposes of satisfying the 75% ownership test, Article 16(1) of the June Draft also establishes a presumption that a corporation with "substantial trading" in its stock on a recognized exchange in its state of residence is owned by individual residents of such state.

Problem: This provision is of little use since it merely creates a presumption of satisfying the 75% test.

The IRS can overcome the presumption merely by requiring the taxpayer to supply proof that the 75% ownership test is actually met. Because the term "substantial trading " is undefined, the IRS could also contend that certain levels of trading are not substantial.

We believe the stock trading provision in Article 16(1)(a) of the Discussion Draft is preferable to the provision in the June Draft. The former eliminates the presumption and permits a corporation to qualify for treaty benefits if, for example, its stock is listed on an approved stock exchange in its country of residence.

Control Test (Discussion Draft)

Article 16(1)(b) of the Discussion Draft denies treaty benefits on income arising in a contracting state (assume

11. See: sections 11 and 7701(a)(3) and (4).
12. See, e.g.: *Moline Properties, Inc. v. Commissioner,* 319 U.S. 436, 438-439, 30 AFTR 1291, 1293-94 (1943), and *Rothschild v. U.S.*, 407 F. 2d 404, 409-10, 415, 23 AFTR 2d 69-637, 642-43, 648 (Ct. Cl. 1969), which synthesizes the judicial standards for shamming a corporation and shamming a transaction, respectively.
13. See: Treas. Reg. 1.11-1(a).
14. As previously stated, under Article 16(2)(e)(ii) a corporation is presumed to meet the principal purpose test and thus be entitled to treaty benefits if the income in question is incidental to, or derived in connection with, the corporation's business operations in the contracting state of which it is a resident. See note 8.
15. As previously stated, under Article 16(1)(b) a corporation of a contracting state is entitled to treaty benefits if controlled by residents of that state or U.S. citizens. Under Article 16(2)(d)(i) a corporation is presumed to meet the above control test and thus get treaty benefits if more than 75% of the corporation is owned directly by U.S. citizens. See note 9.
16. As previously stated, under Article 16(2)(d)(iii) a corporation is presumed to meet the control test and thus get treaty benefits if individual residents of a third country having a U.S. income tax treaty (offering relief as favorable as the treaty in question) own directly more than 75% of each corporation. See note 9.
17. See Article XI(1) of the Canadian Treaty which imposes a 15% withholding tax on U.S.-source interest.

U.S.) to a corporation of the other contracting state (assume Netherlands), controlled by persons who are not residents of that other contracting state, unless such persons are U.S. citizens.

Under Article 16(2)(c) a person (or persons) is treated as having control of such corporation for Article 16(1)(b) purposes if under the income tax laws of the contracting state in which income arises (assume U.S.), "the person or persons could be treated as having direct or indirect control of the corporation for any purpose".

Problem No. 1: The definition of "control" in Article 16(2) of the Discussion Draft refers to control "for any purpose" under the tax laws of the contracting state in which the income arises. Suppose a Dutch corporation wants to claim treaty benefits on U.S.-source income. The Dutch corporation could never be sure that it qualified for those benefits unless shareholders residing in the Netherlands owned enough of its shares to meet the maximum ownership test under any provision of the Internal Revenue Code.

This article provides no guidance as to which ownership rules the IRS or Treasury will use. Thus, the IRS or Treasury would be free to choose among the various ownership tests in ways that could not be anticipated by any investors.

Problem No. 2: Another problem with the definition of "control" is that other states might not have constructive ownership rules or might have control provisions that differ significantly from those of the U.S.

For example, suppose that in country X a corporation is considered to be controlled by country X residents if 40% of a corporation's shares are owned by such residents. It is unlikely that country X will agree to a provision that requires country X residents to own, for example, 80% of any country X corporation receiving dividends or interest from the U.S. before that corporation gets treaty benefits, when U.S. investors in country X have to own only 40% of a U.S. corporation for that corporation to get treaty benefits on income from country X.[18]

Problem No. 3: In many cases, Article 16(1)(b) of the Discussion Draft will cause the U.S. Treasury to collect less U.S. income tax than if treaty benefits had not been disallowed by this Article.

For example, suppose that T, a resident of a country (Y) not having an income tax treaty with the U.S., owns a U.S. corporation. The U.S. corporation does not conduct business operations in the U.S. but receives $100,000 of dividends from sources in country X. The U.S. has an income tax treaty with country X which reduces X's withholding tax rate on dividends from 35% to 10%. If Article 16(1)(b) of the Discussion Draft is not included in the country X treaty, the U.S. corporation would only have to pay $10,000 of country X withholding tax (10% of $100,000) on such dividends. However, if Article 16(1)(b) is included, the U.S. corporation will not meet the control test of that Article since it is owned by a resident of country Y.

The loss of the reduced rate means that the U.S. corporation must pay $35,000 of country X withholding tax instead of $10,000. Because of Article 16(1)(b) the U.S. corporation will claim a greater U.S. foreign tax credit and thus pay less U.S. income tax than if the treaty benefits had been available.

This problem is not cured by Article 16(1)(a) of the June Draft (the 75% test) which requires that more than 75% of the U.S. corporation be owned by residents of the U.S.[19]

Exception to Control Test (Discussion Draft)

Under Article 16(2)(d) of the Discussion Draft, a corporation is presumed to meet the "control test" if:
(i) U.S. citizens,
(ii) individual residents of the contracting state (treaty country) where the corporation claiming treaty benefits resides (assume Netherlands), or
(iii) individual residents of third countries having income tax conventions with the contracting state from which relief from taxation is claimed (assume U.S.) providing relief not less favorable than under the convention with the treaty country (assume U.S.–Netherlands Treaty),

own directly more than 75% of the total combined voting power of all classes of voting stock and more than 75% of the shares of each other class of stock of the corporation claiming the treaty benefits.

Problem No. 1: Article 16(2)(d) of the Discussion Draft is unclear on whether a combination of U.S. citizens, Dutch individual residents, or individual residents of states (having an income tax convention with the contracting state from which relief from taxation is claimed), who own together more than 75% of all classes of the corporation's stock, can meet the 75% test. Article 16(2)(d) should be amended to make it clear that such a combination does meet the 75% test.

Problem No. 2: If the section 385 regulations or similar rules are eventually applied to international transactions, they could accidentally cause a corporation to lose treaty benefits guaranteed to it by the 75% test of Article 16(2)(d) of the Discussion Draft.

For example, suppose that a U.S. corporation is owned by a Dutch corporation. Suppose also that 76% of all classes of stock of the Dutch corporation is owned by an individual resident of a third country having a U.S. income tax treaty providing benefits not less favorable than the U.S.–Netherlands Treaty. The other 24% of the Dutch corporation is owned by a Liberian corporation.

On 1 August 1982, the Dutch corporation becomes indebted to its shareholders in the form of interest-bearing, demand loans with a fixed maturity date. At the time of issuance it was felt that the debt-to-equity ratio on these loans was not excessive, even though the 3:1 safe-harbor ratio was not met. Of this debt, 30% is owned by the third-country individual and 70% by the Liberian corporation. The terms of the debt to each shareholder are identical.

In December 1985, the U.S. corporation pays a dividend to the Dutch corporation.

18. The 80% control test in section 368(c) is used here as an example.
19. See Discussion above, pp. 292-293.

The Dutch corporation claims the reduced rate of withholding granted by Article VII of the U.S.–Netherlands Treaty. In 1986, a determination is made that the shareholder debt-to-equity ratio of the Dutch corporation was excessive. Under Treas. Reg. 1.385-4(c)(1)(i) and 6(a)(2) and (g)(1), the foregoing shareholder debt of the Dutch corporation is reclassified as non-voting preferred stock during 1986, retroactive to its date of issuance.

Until the reclassification, the Dutch corporation appeared to meet the control test of the above Article because 76% of all classes of its stock was owned by an individual resident of a third country having an income treaty as favorable as the U.S.–Netherlands Treaty. However, because of the reclassification of debt to preferred stock, the Liberian corporation owns 70% of one class of the U.S. corporation's non-voting preferred stock. Thus, the Dutch corporation retroactively will not meet the control test of the above Article because the third-country individual does not own more than 75% of the shares of each class of the Dutch corporation's non-voting stock.

Problem No. 3: Other problems with this exception to the "Control Test" are discussed on pages 292 and 293.

Pass-through test (June Draft)

Article 16(1)(b) denies treaty benefits to a corporation of a contracting state (assume Netherlands) whose income is used "in substantial part, directly or indirectly", to pay liabilities, e.g. interest expenses, to persons who are not residents of that state and who are not citizens of the United States. Treaty benefits are lost even if 75% of the beneficial interest in the Dutch corporation is owned by Dutch residents.

Problem No. 1: The pass-through test of Article 16(1)(b) is too severe since it will deny treaty benefits even when no third-country resident is taking advantage of a U.S. income tax treaty.

For example, suppose a Dutch company engaged in business in the Netherlands has a subsidiary in the U.S. The Dutch company is wholly owned by individual residents of the Netherlands. The Dutch company borrows money at low rates in Europe from a Swiss bank, and then loans the money to its U.S. subsidiary in return for an arm's length interest rate. The Dutch company under this Article will lose the benefit of the reduced rate of U.S. withholding tax afforded by the U.S.–Netherlands Treaty, even though more than 75% of the beneficial interest in the Dutch company was owned by individual residents of the Netherlands. The loss occurs because the Dutch company pays interest to a Swiss bank. As presently drafted, Article 16(1)(b) interferes with legitimate business transactions and thus should be deleted. Existing case law is sufficient to deal with any real treaty abuse occasioned by pass-through payments. See *Aiken Industries, Inc. v. Commissioner*, 56 T.C. 925, 933-34 (1971).

Problem No. 2: This provision will deny treaty benefits to, and thus undermine the economic viability of, an international finance subsidiary (IFS) organized by a U.S. corporation in, for example, the Netherlands Antilles to raise capital by selling bonds to European investors.

If an IFS loans the sales proceeds from its bond sales to its U.S. parent, the interest received by the IFS from the parent would be paid to the European investors to meet the interest obligations of the IFS to those investors. Because of this pass-through of interest, the IFS would not be entitled to the reduced rate of U.S. withholding tax on interest received from its parent under Article 16(1)(b). This is a burden for an American business community in need of large amounts of investment capital.

Problem No. 3: Also, Article 16(1)(b) of the June Draft presents various interpretative problems. What is the precise meaning of such phrases as "in substantial part", "to meet liabilities", and "directly or indirectly"?

Because Article 16 of the Discussion Draft does not contain a pass-through provision, we believe it is preferable to the June Draft on this issue.

Principal Purpose Test (June Draft)

Article 16(2) of the June Draft allows treaty benefits to a corporation if it is determined that the acquisition or maintenance of the corporation and the conduct of its operations did not have as "a principal purpose" obtaining benefits under the treaty.

Problem No. 1: Article 16(2) can easily be read to deny treaty benefits to a corporation, even if it meets both the 75% test and the pass-through test of Article 16(1) of the June Draft. If so, treaty benefits will be lost in many cases where there is no imaginable treaty abuse.

At the Treasury meeting of 14 January 1982, however, Treasury personnel responded to this concern by saying that Article 16(2) was intended to grant treaty benefits to a corporation that otherwise failed the pass-through test or the 75% test. In order to conform the language of Article 16(2) to that intent, we recommend that the following words be inserted after the word "apply":

> to cause a loss of benefits . . . under the convention

In summary, we believe that the principal purpose test should be used only to permit a corporation to qualify for treaty benefits when it would not otherwise qualify for such benefits under the other tests.

Problem No. 2: The principal purpose test in Article 16(2) makes it easier for the IRS to deny treaty benefits than would otherwise be permitted by existing case law.

Suppose that a resident of a third country has an appreciable business purpose, such as minimizing non-U.S. taxes, for making an investment in the U.S. through a treaty-country corporation, apart from any U.S. treaty benefit. Despite the presence of such a purpose, Article 16(2) allows the IRS to sham the transaction.

If the transaction is shammed, the investment will be treated as having been made directly by the non-resident person, causing a loss of treaty benefits. This results because the IRS only has to show that obtaining treaty benefits was "a principal purpose" for making the investment through the treaty country corporation. It can then ignore any appreciable business purpose, apart from the treaty benefit, for the investment.

Existing case law, however, will not permit the IRS to sham the above investment transaction if the third-country resident can show that some appreciable economic advantage or disadvantage (business purpose) flows or was reasonably expected to flow from the transaction.[20] If such a business purpose is present for making the investment through the treaty-country corporation, it is irrelevant that the above resident also knew that U.S. treaty benefits would be available to the treaty-country corporation.[21]

We, therefore, recommend that the principal purpose test in Article 16(2) of the June Draft be amended to conform to the standard of existing case law.

Problem No. 3: If Article 16(2) is administered like similar language in existing treaties, it will be useless to taxpayers in many situations.

Article 16(2) gives the IRS and the Treasury unlimited discretion to determine the intent of taxpayers who enter into investments in the U.S. Such discretion makes it impossible for taxpayers to have any certainty of qualifying for treaty benefits, if the principal purpose test is involved. It is unreasonable to expect prudent businessmen to invest significant amounts of capital in the U.S. without some certainty that treaty benefits will not be withdrawn because of purely subjective determinations by the IRS or the Treasury.

We understand that in the past well-intentioned IRS and Treasury personnel have frequently disagreed over the meaning of language similar to Article 16(2).[22]

Often, the positions of each department have fluctuated with personnel changes. Because of these disagreements, the issuance of rulings has often been delayed. Only a handful of favorable rulings has been issued under Article VII(1) since 1978, mostly under familiar fact patterns. We see no good purpose in continuing such an uncertain situation that is not conducive to investment in the U.S.

We think this is another good reason for adopting the recommendation above. We also recommend that Treasury in Article 16(2) provide a non-exclusive list of business purposes for making an investment in the U.S. through a treaty-country corporation that will prevent the investment transaction from being shammed.

Principal Purpose Test (Discussion Draft)

The principal purpose test in Article 16(1)(c) of the Discussion Draft is essentially the same as the test in the June Draft, except that the Discussion Draft clearly sets forth the test as an alternative to claiming treaty benefits. Thus, the Discussion Draft is preferable on this point, but the other problems we have discussed remain.

Equality of Tax (June Draft)

Article 16(3) of the June Draft denies treaty benefits to a resident of the other contracting state on, for example, U.S.-source dividends and interest, when such income bears a significantly lower tax in that other contracting state than dividends and interest arising in that other contracting state.

Problem No. 1: Many contracting states levy income tax only on income arising within their borders and not on foreign-source (including U.S.-source) income. Thus, Article 16(3) would always disallow treaty benefits to residents of such states because the income they derive from the U.S. would always bear a significantly lower tax than similar income arising within their state of residence.

Clearly, it cannot be the treaty policy of the United States to penalize residents of states with territorial tax systems. We therefore recommend that this Article be deleted.

Problem No. 2: Article 16(3) of the June Draft can easily be read to deny treaty benefits to a corporation, even if it meets the 75% test, the pass-through test, and the principal purpose test of Article 16(1) and (2) of the June Draft.

Equality of Tax (Discussion Draft)

Under Article 16(2)(e)(i) of the Discussion Draft, a treaty country corporation (assume Netherlands) is presumed to meet the principal purpose test if "the reduction in [assume U.S.] tax claimed is not greater than the tax actually imposed by the Contracting State. . ." (assume Netherlands) where such corporation is a resident.

Problem No. 1: It is unclear whether (a) the "reduction" in tax refers to an absolute dollar amount or a percentage rate reduction, or (b) whether "the tax *actually* imposed" refers to the tax rate or the actual tax collected in, for example, the Netherlands. If the reference is to the actual tax collected in the Netherlands, a Dutch corporation may never be able to meet this standard if Netherlands-source net operating losses or other deductions significantly reduce the amount of Dutch tax collected on the U.S.-source income in question.

Problem No. 2: Even if this test is met, Article 16(2)(e)(i) of the Discussion Draft creates only a presumption that the above corporation qualifies for Treaty benefits. If this article is retained, the "presumption language" should be deleted.

Problem No. 3: Article 16(2)(e)(i) relief also may be unavailable to corporations resident in states with territorial tax systems.

20. See *Rothschild v. U.S.*, 407 F. 2d 404, 409, 415, 23 AFTR 2d 69-637, 642, 648 (Ct. Cl. 1969), (and cases cited therein); *Gilbert v. Commissioner*, 248 F. 2d 399, 411, 52 AFTR 634, 646-47 (2d Cir. 1957) (Hand, J., dissenting), *cited approvingly in Knetsch v. Commissioner*, 364 U.S. 361, 366, 6 AFTR 2d 5851, 5853 (1960); *Aiken Industries, Inc. v. Commissioner*, 56 T.C. 925, 934 (1971).

21. See *Fabreeka Products Co. v. Commissioner*, 294 F. 2d 876, 878, 8 AFTR 2d 5554, 5555-56 (1st Cir. 1961); *Bass v. Commissioner*, 50 T.C. 595, 601 (1968); *Gilbert* at 646 stating "when a taxpayer supposes that *the transaction*, in addition to its effect on his tax, *will promote his beneficial interest in the venture*, he will of course secure the desired reduction [in his tax] for it *would be absurd to hold that he must deny himself an economic advantage* unless he pays the tax based on facts that have ceased to exist." (Emphasis added.)

22. See Article VII(1) of the U.S.–Netherlands Treaty, as extended to the Netherlands Antilles.

Existing Investments

Problem: Article 16 will render many existing foreign investments in the U.S. and U.S. investments in treaty countries economically unsound by denying their investors the reduced rates of withholding tax. This result is unfair because such investments were made on the understanding that such rates would be available. To avoid this inequity, we recommend that the U.S. Model Treaty and all renegotiated U.S. treaties include a provision that existing investors continue to receive the reduced rates of withholding, even if their investment does not meet the requirements of Article 16.

III. RECOMMENDATIONS

It is our view that Article 16, as proposed, should not be included in U.S. tax treaties. Even if, as a matter of policy, it were desirable to include Article 16 in tax treaties, we think the interpretative problems and the impediments to the conduct of international business presented by Article 16 outweigh any arguments in favor of the adoption of such an Article.

JUNE DRAFT

Article 16
Limitation on benefits

1. A person (other than an individual) which is a resident of a Contracting State shall not be entitled under this Convention to relief from taxation in the other Contracting State unless
a) more than 75% of the beneficial interest in such person is owned, directly or indirectly, by one or more individual residents of the first-mentioned Contracting State; and
b) the income of such person is not used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are residents of a State other than a Contracting State and who are not citizens of the United States.

For the purposes of subparagraph a), a company that has substantial trading in its stock on a recognized exchange in a Contracting State is presumed to be owned by individual residents of that Contracting State.

2. Paragraph 1 shall not apply if it is determined that the acquisition or maintenance of such person and the conduct of its operations did not have as a principal purpose obtaining benefits under the convention.

3. Any relief from tax provided by a Contracting State to a resident of the other Contracting State under the Convention shall be inapplicable to the extent that, under the law in force in that other State, the income to which the relief relates bears significantly lower tax than similar income arising within that other State derived by residents of that other State.

DECEMBER DRAFT - (Discussion Draft)

Article 16
Investment or holding companies

1. A corporation which is a resident of a Contracting State shall not be entitled under this Convention to relief from taxation in the other Contracting State with respect to an item of income, gains or profits unless the corporation establishes that:
a) its stock of any class is listed on an approved stock exchange in a Contracting State, or that it is wholly owned, directly or through one or more corporations each of which is a resident of a Contracting State, by a corporation the stock of which of any class is so listed; or
b) it is not controlled by a person or persons who are not residents of a Contracting State, other than citizens of the United States; or
c) it was not a principal purpose of the corporation or of the conduct of its business or of the acquisition or maintenance by it of the shareholding or other property from which the income in question is derived to obtain any of such benefits.

2. For the purposes of this Article:
a) an approved stock exchange in _____ means _____;
b) an approved stock exchange in the United States means the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for the purposes of the Securities Exchange Act of 1934;
c) a person or persons shall be treated as having control of a corporation if under the income tax laws of the Contracting State in which the income arises the person or persons could be treated as having direct or indirect control of the corporation for any purpose;
d) notwithstanding subparagraph c) of this paragraph, a corporation is presumed to meet the requirements of subparagraph b) of paragraph 1 of this Article if the corporation establishes that individuals who are:
i) citizens of the United States; or
ii) residents of a Contracting State; or
iii) residents of States that have income tax conventions in force with the Contracting State from which relief from taxation is claimed and such conventions provide relief from taxation not less than the relief from taxation claimed under this Convention;

own directly more than 75% of the total combined voting power of all classes of the corporation's stock entitled to vote and more than 75% of the number of shares of each other class of the corporation's stock;

e) a corporation is presumed to meet the requirements of subparagraph c) of paragraph 1 of this Article, in particular, where:
i) the reduction in tax claimed is not greater than the tax actually imposed by the Contracting State of which the corporation is resident;
ii) the corporation is engaged in business operations in the Contracting State of which it is a resident and the relief from taxation claimed from the other Contracting State is with respect to income which is incidental to or derived in connection with such business.

BELGIUM:
Cutting Taxes on Business and Investment Income

by Frans Vanistendael*

I. GENERAL OUTLINE OF NEW TAX MEASURES

During the spring of 1982 a new set of tax measures was introduced in Belgium in what looks like a determined effort to relieve the country of its bad international reputation for high taxes. The measures are aimed at achieving two goals:

a. a general and permanent improvement in the tax environment by a substantial cut in the tax rate on business and investment income;
b. a boost in investment in physical and financial assets by temporary but substantial tax incentives, that will have an effect over a relatively long period of time.

The legal basis for most of the new measures is the Special Powers Act of 2 February 1982. This act enables the government to take sweeping reform measures by Royal Decree, thereby effectively excluding the vote necessary for a formal Act of Parliament. The special powers are granted on a temporary basis and expire 31 December 1982.

Art. 2 of the act enables the government to amend by simple Royal Decree, any existing tax statute, decree or ruling with respect to specifically listed items. However any amendment so effected by Royal Decree is to be confirmed by a formal Act of Parliament before 1 January 1984. Any amendment by Royal Decree that has not been confirmed before that date will lapse thereafter.

The chance of non-confirmation of the measures seems at present very remote, if only because non-confirmation would bring down instantly a whole tax structure that has been built up very carefully.

Under the Special Powers Act, the following tax decrees have already been issued:

(a) 15 February 1982
- Royal Decree No. 1: Reduction of the V.A.T. rate on new construction from 17% to 6%;
- Royal Decree No. 2: Abolition of the capital gains tax on unimproved land situated in areas earmarked for residential construction;
- Royal Decree No. 6: Tax incentives for taxpayers under 35 who start a new unincorporated business or a new profession;
- Royal Decree No. 7: Deduction of a special reserve for severance pay;
- Royal Decree No. 8: Change (reduction) of the tax base for the application of V.A.T. to sales of works of art, antiques, gold and bullion;
- Royal Decree No. 9: Reduction of V.A.T. rate to 1% on gold bullion;
- Royal Decree No. 10: New system of advance payment for taxpayers filing a joint return.

(b) 19 March 1982
- Royal Decree No. 15: Tax incentives for the subscription of shares in Belgian companies;
- Royal Decree No. 16: Reduction of the corporate income tax rate.

(c) 30 March 1982:
- Royal Decree No. 29: Replacement of the tax deduction by a tax credit for income from social security schemes (retirement pensions, sick- and disability pay, unemployment compensation, etc.).

(d) 2 April 1982
- Royal Decree No. 40: Amendments with respect to interest charged for late payment of taxes;
- Royal Decree No. 41: Amendments with respect to criminal sanctions for tax avoidance.

(e) 5 May 1982
- Royal Decree No. 44: Changing the provisions for aggregating the income of husband and wife.

(f) 22 June 1982:
- Royal Decree No. 48: Replacement of existing tax incentives by an investment deduction and tax exemption for capital gains realized on certain business assets.

Comments will be limited to those Royal Decrees that directly affect business activities, i.e. No. 7 on the special provision for severance pay, No. 15 on the tax incentives for the subscription of Belgian shares, No. 16 on the reduction of corporate income tax, and No. 48 on the investment deduction and the exemption for capital gains on business assets.

Finally it should be added that the temporary solidarity surcharges will not be renewed and that negotiations are under way to create a new legal basis for the privileged tax status of foreign executives and research employees.

Discussion of the above measures will be divided into two parts: those of a permanent nature and those which are temporary.

II. PERMANENT MEASURES

1. Reduction of the corporate tax rate

The maximum corporate tax rate will be reduced from a maximum of 56.8% for fiscal 1982 to a single top rate of 45% for fiscal 1983 (income earned in 1982). This reduction is effectuated in two steps.

The first step is the non-renewal of both temporary solidarity surcharges of 4.8% respectively 4% on so called exceptional profits that were introduced by Art. 43 of the Economic Recovery Act of 30 March 1976, and by Art. 48 of the Budgetary Proposals Act 79 - 80 of 8 August 1980. In order to remain in effect, these surcharges had to be confirmed each year by Act of Parliament. There is a political agreement within the government, not to ask for confirmation of the surcharges, so that they will be repealed automatically as of 1 January 1983.

The second step is a reduction of the general top corpo-

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rate tax rate from 48% to 45%. As of fiscal 1983 the structure of the tax rate is the following:

Income (US$)[1]		*Tax rate*
income ≤ 20,000		31 %
	20,000 - 72,000	40 %
	72,000 - 288,000	47.5%
income ≥ 288,000		45 %

It follows that for taxable income below US$288,000 the effective tax rate is lower than 45% and may vary from 31% to maximum 45%.

The tax credit for dividends and directors' compensation has been adopted to reflect the changes in the corporate tax rate. The tax credit on net-dividends (after 20% withholding tax) has been reduced from 57.5% to 51% of the net amount received.

The credit on non-deductible directors' compensation has been lowered from 46% to 41%. The relative importance of the tax credit, aimed at reducing the burden of double economic taxation (combination of corporate and personal income tax), remains unchanged. About half the amount of the corporate income tax (22.44 for dividends and 22.55 for directors' compensation) is creditable against personal income tax.

2. Exemption for capital gains on business assets

The exemption for capital gains on business assets has its historical origins in Art. 9 bis and 9 ter of the Royal Decree implementing the Income Tax Code (I.T.C.). These articles provided for exemption of capital gains realized on certain business assets.
The exemption had to be renewed on an annual basis. This annual renewal rule, combined with the fact that renewals were sometimes very late, rendered the exemption ineffective as a tax incentive.

Therefore the exemption was incorporated in Art. 36 I.T.C. as a permanent measure not subject to annual renewal, by Art. 53 of the so called Program Act of 2 July 1981, Art. 2 e.s. of Royal Decree No. 48 of 22 June 1982 confirms this permanent exemption and determines its application.

As a general rule exemption is granted with respect to capital gains realized on business assets, used during more than five years in business or other professional activity, when the total sales price of such assets is reinvested in new assets in Belgium within a period of three years. The exemption is automatic and not subject to preliminary rulings or approval by the Department of the Treasury or the Department of Economic Affairs.

The three years reinvestment period is calculated as of the first day of the calendar year or the financial year during which the capital gain has been realized, until the last day of the second calendar year (31 December), or financial year, following the (calendar or financial) year in which the capital gain has been realized.

If business activities are ceased at an earlier date, the reinvestment period ends simultaneously with the cessation of business activities.

Example I

Company keeps its financial year from 1 July - 30 June. A business asset is sold in October 1982. Start of the three years reinvestment period: 1 July 1982, end of the reinvestment period: 30 June 1985.

The reinvestment has to be made in new business assets to be used in Belgium. However, the following are not considered as reinvestment: the purchase of goods in trade or inventory, bonds or simular securities, time deposits, loans or claims, buildings or land held for resale as well as the repayment of a debt. However, bonds issued or guaranteed by the Belgian State for a period of more than five years, do qualify as a reinvestment, if purchased by fiancial or similar enterprises. The purchase of company shares or stock, title to patents, copyrights or other non-physical assets are considered as qualifying investments.

The exemption for capital gains is not applicable to assets that have benefited from the investment reserve provided for in Art. 58 of the Program Act of 2 July 1981 or the investment deduction introduced by the same Royal Decree No. 48 (see below). The basic idea is to prevent the taxpayer from combining the benefits of two incentives. This means that the taxpayer has to make a choice between an immediate tax benefit in the form of an investment reserve or deduction in the year of investment or a deferred tax benefit on the capital gain in the year in which the assets will be sold. Taxpayers that have already chosen for the investment reserve in 1981, or will choose for the investment deduction, will not be entitled to claim the exemption for capital gains at the time the asset is sold.

New business assets purchased as a reinvestment to obtain the exemption from capital gains tax do qualify however for the investment deduction described below.

Example II

Purchase of research equipment in 1982. Application of the investment deduction of 20%. Equipment sold in 1988, and sales price reinvested in similar but more modern equipment. Capital gain realized in 1988 is taxable (at lower rate of 22.5%), because of investment deduction of 20% claimed in 1982. New equipment purchased in 1988 does qualify however for the investment deduction.

New assets purchased as a reinvestment can be depreciated in accordance with ordinary rules. Although the capital gain, which in theory originated the cash for the new investment is completely tax exempt, the newly acquired assets are subject to full depreciation like any other business asset.

Example III

Equipment with salvage value of US$10,000 is sold for US$50,000 in 1982 and proceeds are reinvested in 1983, in new equipment with a purchase price of US$200,000. Capital gain of US$40,000 is tax exempt. Amount of up to US$200,000 of new assets can be depreciated.

1. Exchange rate at 50 Bfrs. = US$1.

The exemption applies to all taxpayers engaged in business or professional activities in Belgium: resident individuals and corporations, and Belgian establishments of non-resident taxpayers (individuals and corporations).

3. Investment deduction

The same Royal Decree No. 48 introduces a new investment deduction. The intention of the government was to simplify the complicated structure and the scattered pattern of existing tax incentives, by replacing several existing incentives with one single and simple measure. Removed from the statute books are both of the investment reserves introduced in 1982 (the 5% reserve enacted on 10 February 1981, and the 28 or 30% investment reserve enacted on 2 July 1981), depreciation of research equipment at 110% of acquisition cost and depreciation at will ("ad libitum") of energy saving equipment.

Art. 6 of the Royal Decree provides for a so called "investment deduction" of:
- 25% on energy saving equipment
- 20% on research equipment and new technology
- 5% on furniture and office equipment
- 13% on any other business equipment qualifying under the Royal Decree; i.e. the standard rate of the investment deduction is 13%.

The investment deduction is applied to the acquisition cost of the qualifying assets in addition to ordinary depreciation. It does not decrease the tax base of the assets for the purpose of calculating subsequent capital gains or -losses in case the assets are sold. It follows that the investment deduction is in fact an additional depreciation deduction in excess of the 100% cost base. The investment deduction does not apply to some additional acquisition costs such as taxes, fees, installation- and transportation charges, on which the taxpayer has the option either to deduct such costs as ordinary expenses, or to capitalize such costs and to depreciate them together with the purchase price. If the additional costs are deducted as an expense, the investment deduction does not apply. If however the additional costs are capitalized and depreciated the deduction is applicable.

Example IV

Purchase of equipment at a price of	US$200,000
Packing and transport charges	US$ 10,000
Installation charges	US$ 10,000
Value added tax (V.A.T.)	US$ 37,700

(purchaser is no V.A.T. payer).
If V.A.T. and charges are deducted as an expense, the basis for the investment deduction is US$200,000; if V.A.T. and charges are capitalized and depreciated together with purchase price, the basis for the investment deduction is US$257,700.

In applying the investment deduction the taxpayer has the option either (a) to apply a one time lump sum deduction calculated as a percentage of the acquisition cost of the qualifying asset, or (b) to spread the amount of the deduction over the normal depreciation period of the qualifying asset. In the latter case the amount of the annual investment deduction bears a compounded interest at a rate of 10% per annum to reflect the deferral of the tax saving. It is clear however that in most cases the biggest tax saving (and also the simplest) will be realized by taking the one time deduction for the full amount in the year of investment.

Example V

Purchase of equipment for US$100,000 to be depreciated with the declining balance method over a period of ten years. Depreciation allowance during the first year (at 20%) US$20,000. One time investment deduction: US$13,000. Total deduction during the year of investment: US$33,000, or 33% of acquisition cost.

Example VI

Purchase of vehicle for US$10,000 to be depreciated with declining balance method over five years. Depreciation allowance during the first year (at 40%): US$4,000. One time investment deduction: US$1,300. Total deduction during the year of investment US$5,300, or 53% of acquisition cost.

The investment deduction applies to all taxpayers engaged in business activities (resident individuals and companies), as well as to Belgian establishments of non-resident individuals and companies, including financial and real estate activities that in the past have very often been excluded from the benefit of such tax incentives. Understandably it does not apply to taxpayers that are not assessed on real but on estimated income. For the time being it is not applicable to taxpayers engaged in the professions, but the Decree provides for the possibility to extend the deduction to this category of taxpayers.

The deduction applies to all *new* investment assets used in business activities with the exception of the following categories of assets:
- assets used for mixed purposes (partially business – partially personal);
- assets subject to a depreciation period of less than three years;
- all automobiles and stationwagons used for transport of individuals, except when used solely for taxi- or leasing services (with driver);
- real estate held for sale by taxpayers professionally engaged in real estate activities.

It also applies to assets acquired as a reinvestment within three years of capital gains that are exempt under Art. 36 I.T.C. (see above).

In order to qualify, the assets must be *new*. It follows that land and old buildings (not new construction) do not qualify as well as some intangible assets (such as goodwill) that are generated in the course of business activities, or that already have been partially depreciated. Also excluded are some other assets, because they already benefit from existing tax incentives:
- workmen's housing and other facilities for personnel that benefit from a 50% exemption provided for in Art. 42 I.T.C.
- assets that benefit from the special depreciation at will (Act of 29 November 1977);

- assets that benefit from the repealed investment reserves introduced in 1981 and 1982 (Acts of 10 February 1981 and 2 July 1981).

Finally the investment deduction does not apply to some acquisitions that are not subject to depreciation and can be deducted as ordinary business expenses (or depreciated at 100%) in the year during which the expenses are incurred (see below).

Example VII

Purchase of a business vehicle for US$20,000, to be depreciated with declining balance method. V.A.T. amounts to US$5,000. Total acquisition cost US$25,000.
Deductions in year of investment:
- US$5,000 V.A.T. as business expense if purchaser is no V.A.T. payer
- US$8,000 depreciation allowance for 1st. year
- US$2,600 investment deduction.

Total deduction: US$15,600 or 62.4% of total acquisition cost.

When the amount of the investment deduction exceeds the amount of taxable profits, or when the company realizes a loss, any unused amount of the investment deduction can be carried forward indefinitely. In case of a tax free reorganization the investment deduction is carried over to the surviving company.

4. Depreciation of acquisition cost

In order to determine which items are subject to depreciation and to determine the basis of depreciation, the tax legislation is now harmonized with existing statutes on annual financial statements (Act of 8 October 1976); so that there is no longer any discrepancy between depreciation rules for tax purposes and for accounting purposes. This identity between tax and accounting rules with respect to depreciation has its most important consequence in the field of leasing: henceforth the lessee will be entitled to take depreciation on the leased asset instead of the lessor.

The new Art. 48 § 2 I.T.C. confirms existing administrative practice with respect to expending or capitalizing certain items of acquisition cost. Additional costs of acquisition, or costs of establishment or incorporation of a business can be (a) either capitalized and depreciated together with other assets, (b) or be capitalized and depreciated in accordance with a separate depreciation schedule, (c) or be expended and deducted at once as an ordinary business expense. This rule applies to such additional cost as indirect taxes, local taxes, charges for transportation, packing, installation, fees for experts etc.

5. Provision for severance pay for small business

As is well known in the international business community severance pay in case of firing or lay-off is quite substantial in Belgium, particularly for non-manual employees. Until now, taxpayers were generally not allowed to take any deduction for provisions established for such contingencies as firing or laying-off employees.

Royal Decree No. 7 provides for a tax deductible provision for firing or laying-off employees for small business employing less than 100 employees at the beginning of the calendar year, or financial year (if not identical to the calendar year). The deductible provision amounts to maximum US$800 per additional employee for manual workers and to maximum US$2,400 per additional employee for non-manual workers. The number of additional employees, that have been hired, is calculated by comparison with the average number of employees employed during the preceding (calendar- or financial) year. When the number of employees decreases (because of firing, lay-off, retirement or resignation), previously deducted provisions become taxable in accordance with the category of employees (manual, or non-manual) that has decreased.

6. Tax status of executive and research personnel

The tax status of executive and research personnel of multinational companies has up to 1982 been regulated by administrative circular. This circular in principle expires on 31 December 1982, for employees residing in Belgium before 1 January 1975. Moreover a recent decision of the Supreme Court has cast some doubt on the legal status of these tax privileges. (Cass. 19-11-1981, F.J.F. 1982, 22).

However, the Belgian government has the firm intention of maintaining a special tax status for non-Belgian executive and research personnel, that are hired abroad and transferred to Belgium. Negotiations are under way to find a more solid and more permanent legal basis for this special tax status. At the same time tax benefits would be improved; the main benefits at present being (a) a 30% flat deduction on the first US$100,000 of taxable income for employees of international headquarters and research personnel and of US$30,000 for other employees and (b) the limitation of the tax liability to income from employment earned in Belgium.

III. TEMPORARY TAX INCENTIVES

Royal Decree No. 15 of 9 March 1982 introduced two new tax incentives for the subscription to newly issued or the purchase of existing shares in Belgian companies. The first incentive consists of an exemption from corporate income tax coupled with an exemption from personal income tax for dividends on newly subscribed shares; the second incentive consists of a deduction from personal income of the price of shares purchased in the market. By virtue of its exemption from corporate income tax the first incentives affects Belgian subsidiaries of non-resident parent companies, and non-resident individuals holding shares in Belgian companies. The second incentive affects solely Belgian residents subject to personal income tax.

The new tax incentives replace the old 5% dividend exemption introduced by the law of 29 November 1977 and amended by the laws of 10 February 1981 and 2 July

1981. The 5% exemption indeed proved to be ineffective as a tax incentive.

1. Exemption from corporate income tax

Art. 2 of Royal Decree No. 15 provides for an exemption from corporate income tax during a five-year period for dividends that have been distributed on shares in Belgian companies and other legal entities that were newly issued during the calendar years 1982 or 1983.

The exemption applies only to shares in companies or other legal entities that are subject to Belgian corporate income tax. Shares in non-resident companies having a permanent establishment in Belgium are excluded. The new shares must be issued at the time of incorporation or increase of statutory capital. The shares must be paid in cash. Payment in kind whether made directly or indirectly by having the company first receive the cash and then purchase the assets from its shareholders, does not qualify. The exemption applies to public as well as to limited issues of shares.

Incorporation or capital increases resulting from splitting, merger or other forms of corporate reorganizations do not qualify. Any decrease of statutory capital during the period 1982 – 1983 is deducted from the amount of capital increase qualifying for the exemption, except when the decrease has been necessary to consolidate accumulated losses. Shares acquired in exchange for convertible bonds issued before the starting date of the exemption period do not qualify either.

The exemption is further subject to the condition that at a minimum 60% of the proceeds of the capital increase is invested either in tangible or intangible fixed assets used for business activities in Belgium, or in shares of companies subject to Belgian corporate income tax. The business investment requirement must be met by the end of the first financial year in which the corporate income tax exemption applies. The Secretary of the Treasury has the power to decrease the 60% investment requirement for companies using the proceeds of the capital increase to repay specific debts, to consolidate accumulated losses or to acquire participations in non-resident companies in order to secure supplies of raw materials or fuel, or to secure foreign outlets for the sale of domestic products. In case the acquired assets are sold or otherwise transferred, the proceeds must be reinvested in qualifying assets within a period of three months.

The exemption applies to dividends distributed on the newly issued shares, not of the newly subscribed capital that has actually been paid in. Any capital surplus paid in excess of the face-value of the shares is also taken into account to determine the basis for the exemption. The exemption is increased to 13% of newly paid in capital if and when the company undertakes the obligation to distribute any supplementary income resulting from the tax saving caused by the corporate income tax exemption, to the newly subscribed shares.

Such obligation can in practice only be undertaken in case of the incorporation of a new business, or in case of a capital increase when all newly subscribed shares can be duly identified.

Example VIII

Capital increase of US$1,000,000 in 1982 with obligation to pass on tax savings.
Dividends distributed of up to US$130,000 per annum are tax exempt from 1983 through 1992 (see below).

The exemption is granted for a period of five financial years following the year in which the capital increase has been effectively paid in. However for companies newly incorporated in 1982 or in 1983, or companies effectuating a capital increase within three years of incorporation the exemption is granted from the third through the seventh financial year following the year of incorporation.

Example IX

Company incorporated in 1960, with financial year coinciding with the calendar year. Capital increase in May 1983. Exemption for dividends distributed from 1 January 1984, through 31 December 1988.

Example X

Company incorporated on 15 May 1983 with financial year coinciding with the calendar year. Exemption for dividends distributed from 1 January 1986 through 31 December 1990.

The exemption period is extended however, when the company undertakes the obligation to distribute the tax benefit to the newly issued shares and the exemption is raised to 13%. The exemption period is raised to ten or nine years depending on whether the capital increase takes place in 1982 or 1983.

The ten or nine-year period takes effect, the first financial year after the year of the capital increase, or the third financial year after the year of a new incorporation, or of a capital increase within three years of incorporation.

Example XI

Incorporation of company on 1 July 1980, financial year coinciding with the calendar year.
Capital increase on 10 October 1982, thus within three years, with obligation to distribute tax savings to newly issued shares.
Exemption for dividends distributed from 1 January 1985 through 31 December 1994.

Companies holding shares in other companies can also benefit from the tax exemption of 13% on dividends distributed to them on newly issued and qualifying shares, to which the holding has subscribed, provided the holding company undertakes the obligation to pass through to its newly issued shares any tax saving from which it may itself benefit on dividends distributed by its subsidiary.

Example XII

Company A effectuates a capital increase with shares, qualifying for the 13% exemption, to which company B subscribes.
Company B will also benefit from the 13% exemption on dividends distributed on qualifying shares by company A, provided it (company B) undertakes the obligation to pass through to its shareholders any tax saving it may receive on dividends distributed by company A.

The 8% or 13% exemption remains in effect so long as the company meets the investment conditions, and the obligation to pass through any tax savings to the newly issued shares (only 13% exemption).

Together with the annual tax return a company claiming the exemption must submit a list of the qualifying investments still in use in the company. In case of tax free splitting, mergers or other forms of reorganisation the exemption is carried over to the surviving company.

2. Exemption from personal income tax

In addition to the exemption from corporate income tax described above Art. 3 of the Royal Decree No. 15 provides for a total exemption from personal income tax of dividends of shares that were newly subscribed during 1982 or 1983. Whereas the amount of the corporate income tax exemption is limited to the first 8 or 13% of dividends distributed on paid in capital, the exemption for dividends from personal income tax to the shareholders has no limit.

Example XIII

A dividend of 20% on paid in capital will benefit from the corporate income tax exemption up to 8 or 13% while the balance (12 or 7%) will be subject to corporate income tax. However, the total amount of the dividend distribution (20%) will be exempt from personal income tax.

The total dividend exemption is subject to the condition that the shares on which the dividends are distributed do qualify either for the 8% or for the 13% exemption from corporate income tax.

The period of the dividend exemption is also linked to the period of the corporate income tax exemption (e.g. depending on the corporate income tax exemption the personal income tax exemption is granted for a period of 5, 9 or 10 years (see above)).

It is not required that the shareholder claiming the personal income tax exemption be the original subscriber of the shares i.e. the exemption from personal income tax on qualifying shares is carried over to any resident individual purchasing the shares during the period of exemption from corporate income tax (5, 9 or 10 years).

If the company does not meet the 60% investment requirement set for the corporate income tax exemption (see above) this does not entail the loss of the personal income tax exemption to the individual shareholder, except when the shareholder would act in bad faith.

Whereas a capital decrease for another reason than the consolidation of accumulated losses entails only a proportional reduction of the tax benefit in the corporate income tax, it entails a complete loss of such benefit in the personal income tax, even if only part of the face-value is repaid on each share.

The exemption from personal income tax does not entail an exemption from the withholding tax due at the time of the payment of dividends. The withholding tax of 20% is the sole remaining tax on dividend income, i.e. the total income tax burden on dividends distributed on qualifying shares is limited to 20% and the shareholder receives 80% of total corporate profits after tax.

Dividends on qualifying shares do not have to be reported in the shareholder's tax return. Payment of the withholding tax absolves him from any further tax liability.

However for shareholders in low income brackets (average rate below 43.14%), the existing system of crediting withholding tax and the tax credit on dividends (51% of dividend after withholding tax) remains in effect. Such shareholders have the option to report their dividend income from qualifying shares. The credits from withholding tax (20%) and the tax credit on dividends (51% on net dividend) will then result in an even lower tax burden than the single withholding tax at 20%.

Finally, shares qualifying for the personal income tax exemption, do also qualify the holder of such shares to an exemption from inheritance and gift taxes during a period of up to ten years after the subscription if payment takes place in the same calendar year.

3. Deduction of purchase price of shares

Art. 4 of the Royal Decree No. 15 provides that subject to certain conditions, the purchase of shares, or certificates in Belgian investment funds made between 1 January 1982 and 31 December 1985 entitles the purchaser to a deduction from taxable income of the total acquisition price (within certain limits). In order to qualify, shares must have been issued by a corporation subject to the Belgian corporate income tax. When such shares were issued before 1 January 1982 then quotation on a Belgian stock-exchange is necessary. When issued after 31 December 1981, the company must have undertaken the obligation to invest 60% of the actually paid-in capital in fixed assets upon issuing the shares. Certificates in Belgian investments funds qualify only when the fund has been accredited by the Department of the Treasury, approval which is dependent upon the fund investing at least 60% of its assets in Belgian shares.

The deduction is limited to 40,000 Bfrs. for a single individual and to 50,000 Bfrs. for a married couple. It is increased with 10,000 Bfrs. per dependent. Of course, the amount of the deduction may not exceed the purchase price really paid for qualifying shares or certificates during the calendar year.

The deduction is total, i.e. up to the maximum amount mentioned above, in the year of purchase. However, upon transfer of the shares within a period of 5 years, a fraction of the acquisition price is added to the tax base, the numerator being the number of months between the transfer and the end of such period and the denominator being 60.

Complete reinvestment of the "resale" price within three months or transfer by reason of death or gift to lineal ascendants or descendants does not entail such partial and deferred taxation.

It is clear that the taxpayers wanting to benefit from the deduction will have to report the dividends from the shares on which they claimed the deduction. The deduction of the purchase price of the shares does not entitle the dividends distributed on such shares to an exemption from personal income tax. The normal rules (withholding tax and tax credit) apply. As stated above there is no additional income tax, because of these credits, if the average tax rate of the shareholder does not exceed 43.14%.

As to shares that qualify both for the deduction as well as the exemption, the shareholder has an option. He is presumed to prefer the exemption unless he expressly and irrevocably opts for the deduction in the personal income tax return related to the taxable year wherein the shares were purchased.

CONCLUSION

This brief review of the latest tax measure makes it clear that the tax climate is definitely changing for the better in Belgium. The measures in the field of taxation are coupled with a whole series of Royal Decrees in the field of social security also aimed at reducing the labor cost to business. The Belgian economy is certainly not back in the golden Sixties, but the new tax measures have been rolling back the tax burden on business enterprise at least to the level of the early Seventies.

In next issues:

Integration of Tax Expenditures into the Government Fiscal Management System
– by *Allan J. MacEachen* (Minister of Finance, Canada)

Taxation of Offshore Income and the Canadian Treaty Network
– by *H. Heward Stikeman*

The Influence and Impact of Canada's Tax Accounting Rules on Struturing Canadian Business Operations
– by *Edwin C. Harris*

Working with Canada's Statutory and Discretionary Industrial and Petroleum Assistance Programs
–by *Peter McQuillan*

Structuring Investments and Business Start-ups in Canada
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The Tax System of the People's Republic of China
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Taxation of Consultancy Fees in Nigeria
– by *A.C. Ezejelue*

Role of Income Tax Incentives in Industrialization in Pakistan During the Seventies – A Critique

by Ahmad Khan*

A. PHILOSOPHY OF TAX INCENTIVE PROGRAMS

Tax incentive legislation is generally designed to promote certain socio-economic goals. These goals may include the development of manufacturing or industrial sectors in the economy, dispersal of the industries to less-developed (or pre-industrial) geographical areas or places (which are or may be the source of raw materials), developing import substitution and export oriented industries, attracting foreign capital and technology and, in the process, helping to create a socio-economic order which provides ample opportunities for employment, development of technical skills and adequate supply of goods and services for public consumption. The net result of the complementary fiscal measures (in the present context, income tax incentives) should be to encourage savings, stabilize the economy (and, of course, industrial growth), strengthen the balance of payment position, narrow down the gap in industrialization of various geographical regions of the country concerned, and utilize fully available technical skills and manpower. With these ends in view, appropriate tax incentive programs are envisaged and supplement the various non-fiscal and monetary measures intended for the same purpose.

The present study describes the role of fiscal incentives in the industrial development of Pakistan in the context of the overall economic strategy during the decade 1970-80. It identifies the economic priorities and the fiscal measures adopted during this period in historical sequence. In conclusion, an attempt has been made to evaluate the impact of income tax concessions in achieving the economic goals for which such measures were designed.

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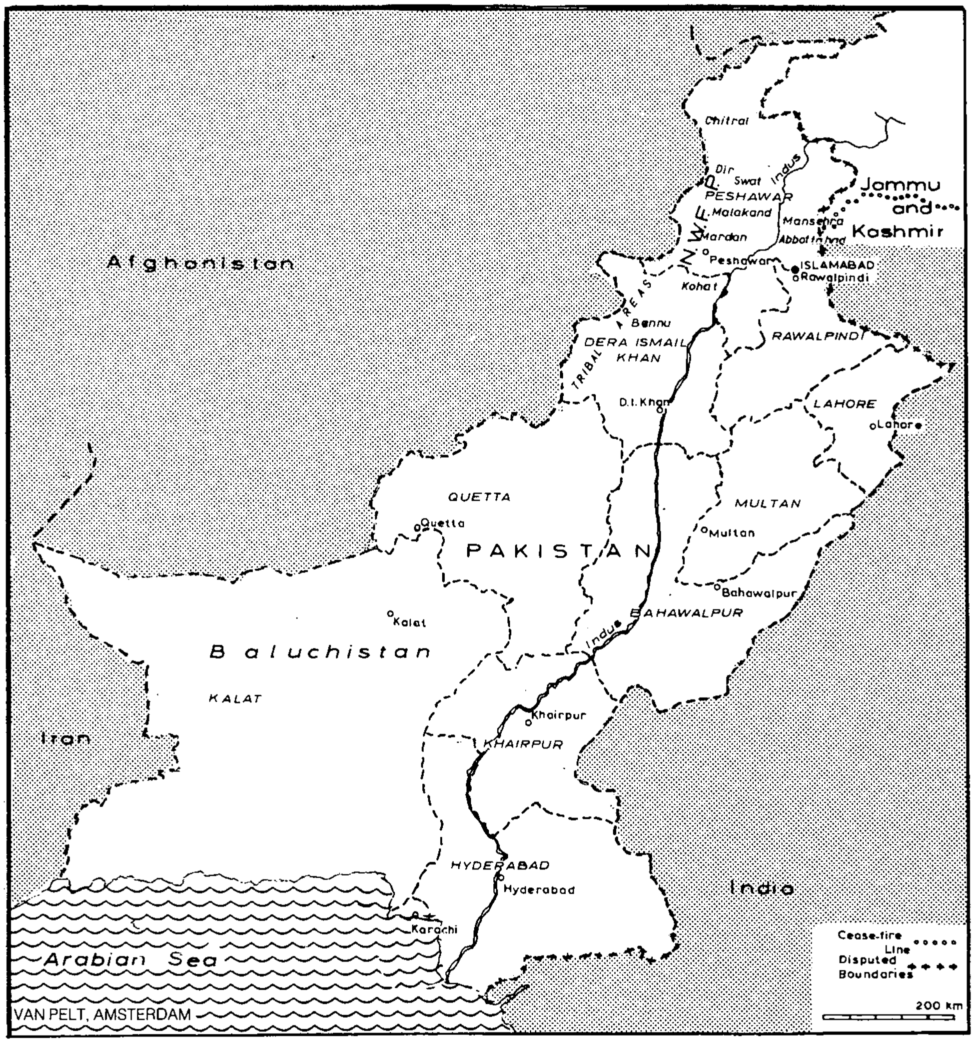

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B. HISTORY OF TAX INCENTIVES IN PAKISTAN

The present study of the tax incentive legislation relates to the post-1970 period. It is, therefore, imperative to glance briefly through the economic scenario prevailing in 1970, the economic plan strategy announced through the Fourth-Five-Year Plan 1970/75[1] and the ensuing political and economic considerations requiring changes in the Plan Strategy accompanied by the changes in the fiscal policies. This will serve as a background to the legislative intentions behind the various tax measures adopted with a view to accelerating the pace of industrial (and, of course, the overall economic) development in Pakistan.

At the time of its independence in August 1947, Pakistan inherited an almost negligible industrial base, and also other infrastructural facilities were non-existent. In FY 1949/50, the industrial sector contributed 7.7% towards GDP of which 5.5% was accounted for by small-scale manufacturing. The value added in large-scale manufacturing increased to 8.8% in FY 1968/69, reflecting a growth rate of 14% over the two decades. During the 1950s, the aggregate growth rate recorded by large-scale manufacturing was as high as 16.3% and during the Second Five-Year Plan 1960/65, it was 13.0%.[2] Industry during this period passed from an initial concentration on cotton and jute textile to sugar, vegetable ghee and cement, and later on to more sophisticated chemical and engineering industries.[3] The considerable increase in industrial capacity was largely caused by the governmental effort in developing infrastructural facilities. A major stimulus was the creation of public corporations to play a pioneering role in establishing such industries, which the private sector was unable to undertake either because these industries were technologically complex or needed large investments. The Government further established specialised credit institutions and, to fill up the technological gap, set up engineering universities, colleges and industrial advisory institutes. These promotional activities were strengthened by providing fiscal concessions and a sizeable allocation of foreign exchange resources at subsidised prices to the industrial sector. As a result of the combined efforts of the public and private sectors, the manufacturing sector showed an impressive performance. Nevertheless, excessive protection and extra liberal concessions also led to the establishment of many inefficient industries and the neglect of productivity in general. While import substitution occurred regarding consumer goods, there was relatively little headway towards the production of capital goods. The net result was that whereas a great deal was accomplished in building an industrial sector from scratch, the more complex and challenging task of creating a balanced, efficient and modern industrial sector was not tackled satisfactorily.[4]

The Fourth Five-Year Plan 1970-75

With the prevailing economic scenario in mind, the Fourth Five-Year Plan 1970/75 stated that its policy was to provide for an adequate measure of flexibility in respect of unresolved issues. At the same time it would constitute a definitive and positive start in areas where no doubts existed about future trends and driving forces. The Plan suggested concrete proposals through which income inequalities could be reduced and equal opportunities assured for all people. It was also expected to serve as a vital instrument of accelerating development of less-developed areas.[5]

While referring to its strategy for private investment, the Fourth Plan stated that "Pakistan has a mixed economy with large part of the production activities in the private sector", and "it may appear surprising that the main emphasis in planning in Pakistan has been in the public sector". Nevertheless, "during the second Plan, the private sector strategy involved the setting up of an incentive mechanism sufficiently attractive to obtain a high investment response and evolution of an institutional framework for channelling real resources to the private sector to translate investment demand into physical investments. The absence of detailed and restrictive planning for the private sector combined with very powerful incentives and sizeable credit availability had the advantage of turning the private sector into a dynamic force. However, there was very little attention paid to the quality of investment, efficiency in the use of resources and consistency of private sector development with social goals."

During the Third Plan 1965-70, the conflict between the pursuit of social objectives and the maintenance of powerful incentives for private investment became obvious, and "many policy shifts were made". Therefore, for the Fourth Plan, it was considered "imperative to look deeper into the behaviour of the private sector and to start the process of integrating the private sector more adequately into overall national planning". Prior to the Fourth Plan, the strategy for the private sector "was based essentially on the premise that capital is shy and that enterprises need to be brought up with the help of special incentives in the form of subsidies, protection and tax concessions. Thus, a powerful and effective system of incentives was evolved over the years and, within the given framework, private enterprise was left free to exercise its option with a view to maximising its rate of return. The system produced results and has been responsible for a very high rate of industrialization." This strategy for the private sector resulted in a continuous rise in the cost of development. "Essentially the protection of infant industries, which are at times quite inefficient, implied that consumers have to pay high prices. The concessions to industry mean that others have to bear a large burden of taxation".[6]

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1. The Pakistan Government appointed a Planning Board in July 1953 to review the development that has taken place since independence and to prepare a national plan of development based on the fullest possible utilization of available resources. The First Five-Year Plan 1955-60 was published in May 1956 and it was subsequently revised in 1957 on the basis of public comments. Since the formulation of the First Plan, the Pakistan Government has formulated the Second (1960-65), Third (1965-70), Fourth (1970-75) and Fifth (1975-80) Plans. The Sixth Five-Year Plan is in the process of formulation.
2. *Pakistan – Basic Facts 1979-80,* Chapter 5, Paras. 1-2.
3. Ibid., Para. 5.
4. Fourth Five-Year Plan (1970-75), Chapter 1, Para. 14.
5. Fourth Five-Year Plan (1970-75), Introduction.
6. Fourth Five-Year Plan (1970-75), Chapter 6, Paras. 1-8.

The Fourth Plan further stated that "the first element of new strategy is the recognition that over the years we have now developed an aggressive and dynamic private sector, quick to respond to profit incentives and capable of setting up and running large industrial business and service enterprises. Apart from the establishment and experience, there is a sizeable class of potential new entrants who are being attracted by the demonstrated success of the others. *The incentive mechanism is no more needed on a general basis, but more selectively for correcting regional imbalances and reducing the handicaps from which new entrants suffer.*" As to the old and more established industries they "have to acquire the level of efficiency where they would need a minimum of special incentives and protection."

Objectives: Increase of industrial production and closing the foreign exchange gap

As to the overall Fourth Plan Strategy on industrialisation, it had two inter-related objectives, viz., output of the industrial sector must grow at 10% per annum, and the foreign exchange gap should be kept within manageable limits, by maintaining the momentum of manufactured exports and replacing a larger proportion of imports, particularly of engineeering goods and imported raw material. The Fourth Plan envisaged a long-term view of export possibilities in the industrial sector and "shifting the structure of production towards other lines in which [we] possess, or may be reasonably expected to develop, a comparative advantage". The Fourth Plan indicated that for the purposes of industrialisation, criteria such as those relating to increased production for export and for import substitution, relatively higher value added, appropriate employment opportunities, encouragement of indigenous capital goods industry, etc. would be kept in view. Simultaneously, "reliance will continue to be placed on private investment for the bulk of industrial investment during the Fourth Plan in West Pakistan other than the less developed areas . . . . Public investment in manufacturing will be undertaken only in those cases where private investment is not forthcoming, where a joint venture cannot be organized or where considerations of national interest dictate public investment." As to the less-developed areas, "effective steps will be taken by way of fiscal and other measures to improve the investment climate . . . ".

The Fourth Plan Strategy, however, could not be implemented in the wake of the 1971 war with India and the shift in the overall socio-economic policies of the new government. A large portion of the industrial sector was taken over by the government and reserved for the public sector. The private sector was left with only a very small sector of capital intensive industries and as such the fiscal measures were oriented more towards developing public sector industries. In the process, generous tax exemptions and subsidies were granted to public sector industries, especially in the form of concessions to the foreign component of the capital outlays and the sophisticated technology needed for these projects.

Change in industrial development strategy

The poor performance of the manufacturing sector in the mid-1970s prompted the Government to initiate important changes in Pakistan's industrial development strategy in 1977/78. The new industrial development policy aimed at encouraging private sector participation while reducing the scope of the public industrial sector and improving the latter's operational and organizational efficiency. In 1977/78 agro-processing units were denationalized, and a re-demarcation policy was announced permitting private sector involvement in many fields previously reserved for the public sector. The measures taken in 1978/79 included the exemption from import duties for textile machinery required for balancing*, modernization, and replacement (BMR) and for the manufacture of garments and made-up textile goods; the introduction of export subsidies for cotton textile products ranging from 7.5% to 12.5%; and the abolition of excise duties on the manufacture of cotton yarn and fabrics. In addition, import procedures were streamlined for machinery valued up to 2.5 million Rs. In 1979/80 export rebates were extended to engineering goods, canvas footwear, and acetate yarn. In 1980/81 the authorities continued the policy of encouraging private sector investment by simplifying government investment approval procedures.

First, the ceiling below which private sector projects are exempt from approval procedures was doubled to 20 million Rs.

Second, machinery up to 10 million Rs. is now allowed to be imported under the Non-Repatriable Investment (NRI) Scheme or against cash licenses without government approval, provided that the projects do not fall within the "negative list" of industries which the Government does not want to encourage; previously the cutoff limit was 5 million Rs.

Third, establishment of new import-based industries (defined as those depending on imports for 50% or more of their input requirements) no longer needs the approval of the Economic Coordination Committee of the Cabinet, provided their annual import requirements are less than 5 million Rs; previously, all import based projects needed approval irrespective of their imported inputs.

Fourth, the role of the Central Investment Promotion and Coordination Committee, the agency which approves projects proposed by IPB, PICIC, and IDBP, was curtailed; only projects of 20 million Rs. or more

* *Editor's note:* The term "balancing" (of machinery) means installation of additional machines in an industrial unit for the purposes of achieving optimum efficiency of the various inter-related components of that unit. For instance, in the textile industry, if an industrial undertaking has both yarn-producing and weaving facilities, 25,000 spindles "balance" with 500 looms. Therefore, if such an undertaking does not have the spindles and looms in the appropriate proportion, either the spindles or the looms would be working below capacity resulting in less than optimum efficiency. Installation of additional looms or spindles, as the case may be, to bring about the right proportion between the two would mean "balancing" of the existing machinery. Similar standards can be found for the ideal capacity of machines involved in intermediate stages of production from raw material to the end product.

sanctioned by IPB are now subject to review by the Committee, which has been reduced in size and renamed the Central Investment Promotion Council.[7]

On the income tax side, selective tax concessions for industrial undertakings established in less-developed geographical regions, viz., Baluchistan, N.W.F.P. (North-West Frontier Province), parts of the Punjab and Sind Province were granted during the fiscal year 1974/75. The process of granting income tax concessions to the manufacturing industry and export oriented trade accelerated during the subsequent years and tax incentives in the form of tax-holidays, investment credits, tax rebates, etc. were introduced to revitalize the process of industrialization in the country.

C. TYPES OF TAX INCENTIVES INTRODUCED IN PAKISTAN

Pakistan has adopted a variety of income tax incentives, which generally include:
(1) tax holidays, (2) tax rebates, (3) tax credits, (4) investment credits or rebates, (5) accelerated depreciations, (6) other investment-related tax incentives.

The types and extent of the tax incentives introduced since 1970 have varied depending upon overall economic priorities, as reflected in the Fourth and Fifth Five-Year Plans and the Finance Minister's budget speeches. The valid economic reasons, at times, gave way to the introduction of some ad hoc tax concessions, which, if looked at in the overall scheme of economic strategy, may not appear as a part of the overall package, and overlap some of the existing tax incentives. The net result, as we may see in the latter parts of this study, has been or still is the grant of too liberal concessions.

The position of various tax incentive programs during the period under study, i.e. July 1970 to June 1981, is as described below:[8]

1. Tax holidays

These include total or partial tax concessions to new industries set up in selected geographical regions, certain sectors of industries and to certain types of income.

a. Area-wise tax holidays

(i) The tax holidays scheme introduced in 1959 envisaged complete tax exemption for new industrial undertakings for a prescribed period of 4, 6 or 8 years depending upon the geographical location of such industries. It was further liberalized in 1966 by relaxing the condition for reinvestment of tax-exempt profits from 60% to 40%. The condition of reinvestment was altogether removed in 1968. In 1970, i.e. the end of the tax holiday period, it was decided to extend for an additional two years partial tax exemption to industries set up before 1 July 1970 is an industrial estate established by the Government or an authority thereof.[9] The tax holiday scheme was suspended by the 1971-72 assessment year, and it was decided that the tax realized for this year from companies eligible for the tax holiday would be allowed as a credit against the tax liability for the period following the expiry of the tax holiday. In 1972-73, the tax holiday scheme was abolished with retrospective effect from the assessment year 1971-72.[10]

(ii) The fiscal concessions in terms of a tax holiday on the basis of geographical location of new industries were not extended during the fiscal year 1974-75.

(iii) During the fiscal year 1975-76, a partial tax exemption was granted with respect to the income of companies registered under the Companies Act, 1913, earned between 1 July 1975 and 30 June 1981 from industrial undertakings commencing commercial production during this period to the extent of:
  (a) 10% of capital if the undertaking is located in Baluchistan, Tribal Areas, and Azad Kashmir.
  (b) 5% of capital if it is located in other areas (excluding the Talukas of Karachi and Hyderabad and Tehsils of Lyallpur and Lahore and such adjoining areas as may be notified by the Federal Government).[11]
  (Section 15B of the Repealed Income tax Act, 1922).

(iv) During the fiscal year 1976-77, the partial exemption granted under (iii) was restricted only to those industrial undertakings which are formed other than by splitting up or by reconstruction or by transfer to a new business of any plant or machinery used in a business being carried out in Pakistan prior to 1 July 1975.

(v) The existing relief provisions under which an investment deduction of 10% of capital was granted to industrial undertakings registered under the Companies Act, 1913 between 1 July 1975 and 30 June 1981 and commencing commercial production during the same period were, during the fiscal year 1978-79, turned into a full exemption for 5 years (from the month in which the industrial undertaking was set up or commenced industrial production, whichever is later) for undertakings established in Baluchistan, the Tribal Areas, the Northern Areas and Azad Kashmir. This exemption was further extended to similar industries established in the Districts of Mansehra, Kohistan, Northern Areas, and Tribal Areas

7. IMF Study on Economic Situation in Pakistan.
8. The summarised position of the various tax incentives as prevailing in Pakistan at present is given in Appendix I.
9. The Finance Minister in his Budget Speech for the year 1970-71 stated that the tax holiday played an important role in bringing about the rapid industrialization of the country. Due to the lack of infrastructure and other facilities, entrepreneurs found it difficult to start industries in the 6-year tax holiday zone and, of necessity, converged on the Government-established industrial starts located in the four-year tax holiday area, further extension of industries set up during Fourth Five-Year Plan period was of vital necessity.
10. The Finance Minister in his Budget Speech for 1972-73 stated that the "notorious" tax holiday scheme was being abolished as it did not achieve its purposes of industrial disposal but, instead, contributed to the concentration of economic power and wealth and encouraged the establishment of uneconomic units. The Government, instead, considered it a sufficient incentive to give full exemption from import duties in case of capital equipment to be installed in less-developed areas, and also to revive the Equity Participation Fund for giving support to private entrepreneurs who propose to set up industries in less developed areas.
11. The Finance Minister in his Budget Speech for the year 1975-76 stated that since 1969 there had been stagnation in private investment in large scale industries. Some improvement occurred in the recent past and the stock exchange showed some buoyancy. With a view to further strengthening this trend, new fiscal incentives (including the tax holiday) were being introduced. No adjoining areas were announced as referred to in the Fiscal measures.

established during the period between 1 July 1979 and 30 June 1983.

(vi) During the fiscal year 1979-80, income of companies registered under the Companies Act, 1913 from an industrial undertaking established in under-developed areas, whose income is equal to 5% of paid-up capital and which were hitherto exempt from tax were made to qualify for such tax exemption on income equal to 10% of paid-up capital.

(vii) During the fiscal year 1978-79, an exemption was allowed with respect to the income of companies registered under the Companies Act, 1913 from an industrial undertaking set up between 1 April 1978 and 30 June 1983 for a period of 5 years beginning with the month in which the commercial production commences (whichever is later) if such an undertaking is set up in the Divisions of D.I. Khan Malakand in N.W.F.P. province.[12]

(viii) During the fiscal year 1978, a similar tax exemption was allowed with respect to the income of companies registered under the Companies Act, 1913 from an industrial undertaking set up between 1 March 1978 and 30 June 1983 in the province of Baluchistan.[13]

(ix) During the year 1980-81, income of companies registered under the Companies Act, 1913 from industrial undertakings set up in industrial estates in the whole of N.W.F.P., district of D.C. Khan, Mianwali and Tehsil Khushab in Punjab, and districts of Dadu (excluding Kotri), Jacobabad and Shikar-pur in Sind were exempted for a period of 5 years from the date of setting up of the undertaking or commencement of commercial production (whichever is later).[14]

b. Income-wise tax holidays

(1) *Dividends*

(i) During the fiscal year 1970-71, dividends paid out of capital gains on which tax had already been paid by the company or firm of which such person was a shareholder or a partner were exempted from income tax (S.14(4)) of the Repealed Income tax Act, 1922). This exemption was withdrawn during the year 1971-72 to the extent that the dividends paid out of the taxed capital gains were made liable to tax in a manner similar to dividends paid out of any other taxed income.[15]

(ii) During the fiscal year 1972-73, dividends received by a private company were made liable to taxation at normal rates. Intercorporate dividends in the hands of a public company continued to be taxed at the concessional rate of 15%.

(iii) During the fiscal year 1978-79, the existing preferential tax treatment accorded to dividends from NIT and ICP mutual funds was discontinued. From then onwards, dividends received from any company listed at stock exchange or from NIT or ICP mutual funds was exempted to the extent of 15,000 Rs. per annum.

(2) *Capital gains*

Capital gains from the disposal of movable assets (capital stocks of joint stock companies, etc.) have been exempt from income tax during the period beginning 1 July 1975 onwards. The exemption is available up to 30 June 1983. Capital losses during these years have been allowed to be carried forward for setting of against the future capital gains.[16]

c. Sector-wise tax holidays

(i) *Income from the manufacture of agricultural machinery:* Income derived from sales during the period 1 July 1968 – 30 June 1983 from the manufacture (not assembly of specified agriculture machinery and component parts thereof, provided the latter can be easily fitted into their places in these implements and cannot ordinarily be used for purposes other than agriculture, is totally exempt from levy of income tax.[17]

(ii) *Income from renting out of agricultural machinery, etc.:* Income derived from the business of renting out of machinery for agricultural operations, or providing pest control services to agriculturists, is exempt from income tax for a period of 2 years from the date such business is set up provided that the business has been or is set up during the period 1 July 1976 and 30 June 1983.[18]

(iii) *Income from storage and preservation of food grains, etc.:* Income derived from a business of providing services for the storage and preservation of food grains through scientific drying, fumigating and storing is exempt from income tax for a period of 5 years from the date of setting up of such business during the period 30 October 1969 – 30 June 1980.[19]

(iv) *Income from poultry farming, etc.:*

(a) Income derived during the period between 1 July 1971 and 30 June 1983 from poultry farming, fish catching and cattle or sheep breeding is exempt from income tax.[20]

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12. See SRO. 317(I)/78 dated 25 March 1978.
13. See SRO. 234(I)/78 dated 2 March 1978.
14. See Clause 82A of Second Schedule of the Income Tax Ordinance, 1979.
15. The Finance Minister in his Budget Speech for 1971 felt that there was no justification for giving preferential treatment to dividends out of taxed capital gains as compared with dividends from other types of taxed income. The measure was introduced as a step towards achieving neutrality in all types of income.
16. The tax concession was for the first time introduced in 1977 for a period of 2 years through an amendment in S.17(5) of the repealed Income Tax Act, 1922. It was further extended for a period of 2 years through the Finance Ordinance Acts of 1976, 1978 and 1980.
17. The tax exemption was for the first time allowed for a period of 5 years during FY 1968-69 through SRO 25(K)/68, dated 20 November 1968. The exemption period was subsequently extended through a series of amendments in this notification, viz., SRO.371(I)/71, dated 17 June 1972, SRO.960(I)/71, dated 28 June 1973, SRO.1535(I)/74, dated 19 December 1974, SRO.648(I)/76, dated 1 July 1976, and the Finance Ordinance, 1980. The tax exemption is now contained in Clause 98 of Part I of the Second Schedule to the Income Tax Ordinance, 1979.
18. The tax exemption was first introduced during FY 1976-77 through SRO.649(I)/76, dated 1 July 1976. The exemption period expiring on 30 June 1980 was subsequently extended to 30 June 1983 through the Finance Ordinance, 1980. The tax exemption is now contained in Clause 96 of Part I of the Second Schedule to the Income Tax Ordinance, 1979.
19. This tax exemption was first introduced through SRO.225(I)/69, dated 21 October 1969. The exemption, as expiring on 30 June 1975, was subsequently extended to 30 June 1980 through SRO.647(I)/76, dated 1 July 1976.
20. See SRO.142(I)/70, dated 1 July 1970. The exemption, expiring on 30 June 1976, was extended first through the Finance Ordinance, 1975 (by amending S.4(3)(xx) of the repealed Income Tax Act, 1922 and then through Finance Ordinance, 1980 by introducing Clauses 64-A and 64-B in Second Schedule of the Income Tax Ordinance, 1979. Presently, the provision appears at Clause 99 of Part I of the Second Schedule to the Income Tax Ordinance, 1979.

(b) Income derived during the period between 1 July 1980 and 30 June 1983 from the business of poultry processing is exempt from income tax.[21]

(c) Income derived during the period between 1 July 1971 and 30 June 1983 from the business of dairy farming is exempt from income tax.[22]

(d) Income derived from an industrial undertaking manufacturing cattle or poultry feed as set up prior to 1 July 1971 for the period 1 July 1971 – 30 June 1975 was exempt from income tax.[23]

(e) Income derived during the period 30 June 1977 – 1 July 1982 from fish farming established after 1 July 1977 is exempt from income tax.[24]

(v) *Miscellaneous income:* Income of cooperative societies as derived from dealings with their members from the business of granting agricultural or rural credits; cottage industry; marketing of agricultural produce of their members; purchase of agricultural implements, seeds, livestock or other agricultural articles for supply to their members; ordinary processing of agricultural produce of their members to render the produce fit for marketing; letting of godowns or warehouses for storage, processing, etc. for their members is totally exempt from income tax.[25]

d. Exemption for the garment industry

During the year 1978-79, income of a company registered under the Companies Act, 1913 as derived from an industrial undertaking set up between 1 July 1978 and 30 June 1983, was exempt from tax for a period of 5 years beginning with the month in which the industrial undertaking is set up or commercial production is commenced (whichever is later) engaged in the manufacture of garments from cloth manufactured in Pakistan.[26]

e. Exemption for industries engaged in processing of dates, manufacture of chipboard or straw board or refining of edible oil

During the year 1978-79, income of a company registered under the Companies Act, 1913, from an industrial undertakings set up between 1 May 1978 and 30 June 1983, in the District of Sukkur in Sind Province and engaged in processing of dates, manufacture of chipboard or straw board or refining of edible oil, was exempted for a period of 5 years beginning with the month in which the undertaking was set up or it commenced commercial production (whichever is later).[27]

f. Exemption to mineral industries

During the year 1981-82 income of Pakistani companies engaged in the exploration and extraction of a selected number of minerals (other than petroleum) derived from industrial undertakings set up between 1 July 1981 and 30 June 1985 were exempt from income tax for a period of 5 years from the date of commercial production; and after expiry of the 5 years, tax on such income was levied at 50% of the normal rate for the next 5 years.[28]

2. Tax rebates[29]

Tax rebates allowed to the various industries during the period 1970 – 1981 include:

(i) Refundable surcharge (discontinued by virtue of the Finance Ordinance, 1970).

(ii) Tax at 10% on excess free reserves of companies (abolished by virtue of the Finance Ordinance, 1971).

(iii) Surcharge levied through the Finance Ordinance, 1970 (abolished from the assessment year 1972-73).

(iv) Flood relief surcharge on income tax (abolished by virtue of the Finance Ordinance, 1974).

(v) Super tax rebate at 5% was allowed to companies setting up industrial undertakings between 1 July 1975 and 30 June 1980 if their fixed assets did not cost more than 3 million Rs. (excluding cost of land) by virtue of the Finance Ordinance, 1975. During the year 1980-81, this concession was extended up to 30 June 1983. The relief was also extended in scope, viz., to companies owning assets of value of 5 million Rs. as against 3 million Rs. previously.

(vi) Export rebate at 25% of the tax attributable to income derived from approved items after 1 July 1975 allowed to manufacturers exporting such goods (Finance Ordinance, 1975). The tax rebate was increased from 25% to 50% in fiscal year 1976-1977. The scope of this concession was also extended to commercial exporters. During the fiscal year 1979-80, the tax rebate was further increased to 55%.

(vii) During the fiscal year 1977-78, the rate for inter-corporate dividends in case of private companies was reduced from 50% to 30%.

(viii) During the fiscal year 1980-81, the rebate on the surcharge on retained earnings was enhanced so that the rebate would bear the same ratio to the surcharge as the retained income bears to after-tax profits. The concession was restricted to those companies whose free reserves did not exceed 150% of the paid up capital.

(ix) Rebate of surcharge on companies was reduced from 10% to 5% during the fiscal year 1981-82. For the purpose of surcharge in case of financial institutions, the limit of reserves was raised to 300%.

3. Tax credits

The concept of tax credits was first introduced during 1974. The various measures adopted to date include:

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21. Exemption granted through the Finance Ordinance, 1980. See Clause 100 of Part I of the Second Schedule to the Income Tax Ordinance, 1979.
22. See footnote 9 above. It appears at Clause 101 of Part I of the Second Schedule to the Income Tax Ordinance, 1979.
23. See SRO.41(I)/70 dated 1 July 1970.
24. Tax exemption introduced through the Finance Ordinance 1977, by incorporating Clause (xxi) to S.4(3) of repealed Income Tax Act, 1922.
25. See Clause 103 of Part I of the Second Schedule to the Income Tax Ordinance, 1979.
26. See SRO 973(I)/78, dated 1 July 1978. The exemption now appears at Clause 125 of Part I of the Second Schedule to the Income Tax Ordinance, 1979.
27. See SRO 574(I)/78, dated 18 May 1978. The provision now appears at Clause 124 of Part I of the Second Schedule to the Income Tax Ordinance, 1979.
28. See Clause 123 of Part I and Clause 1 of Part II of the Second Schedule to the Income Tax Ordinance, 1979.
29. A number of new industries were set up during the years 1974-75 onwards. In order to maintain this trend and also to encourage private savings and investment, government took suitable measures to follow a relatively liberal scheme of reduction in taxes. In this context, see the Finance Minister's Budget Speech for the year 1974.

(i) Finance Ordinance, 1974 provided tax credits to companies making an initial investment in shares of new industrial undertakings as approved by CBR at:
   (a) 30% of such investment if the industrial undertaking is set up in Baluchistan, Tribal Areas, Northern Areas and Azad Kashmir;
   (b) 15% of investment if it is set up elsewhere in Pakistan; except Talukas of Hyderabad, Karachi, Tehsil Lyallpur and Lahore and such adjoining areas of Tehsil Lahore as may be notified by the Federal Government (no such areas have actually been notified to date).[30]

(ii) During the fiscal year 1975-76, the above tax concession was also made admissible in respect of identifiable expansions carried out after 1 July 1975.

(iii) Pakistan companies investing any amount in the purchase of plant and machinery for installation between 1 July 1976 and 30 June 1983 in an industrial undertaking for the purposes of replacement, balancing or modernization of already installed plant and machinery are allowed a tax credit of 15% of the amount so invested. The unabsorbed tax credit can be carried forward for adjustment against the future tax liability.[31]

(iv) Pakistani companies making an initial investment in shares or debentures issued by the Equity Participation Fund established under the Equity Participation Fund Ordinance, 1970 as approved by CBR, were allowed a tax credit equal to 50% of the amount so invested. Provisions were also made to carry forward any unabsorbed tax credit (which is redeemable in the year in which such shares or debentures are sold, transferred or disposed of).[32]

(v) During the fiscal year 1980-81, a tax credit for investment in debentures or negotiable bonds issued by the Government or a government owned corporation (approved by CBR for this purpose) was allowed to the extent of 5% of the nominal value of such bond or debenture. The unabsorbed tax credit was allowed to be adjusted during the subsequent years.[33]

4. Investment credits

Under this method, a specified percentage of new investment is allowed as a reduction while computing taxable profits. The various measures taken during the period from 1970 onwards include:

Income of a Pakistani company derived from approved industrial undertakings set up in the territories of Pakistan (excluding Talukas of Karachi and Hyderabad and Tehsils of Faisalabad and Lahore and such adjoining areas of Lahore Tehsil as notified in this behalf by the Federal Government) not exceeding 10% of the capital employed is exempt from income tax, provided it has commenced its commercial production during the period from 1 July 1975 to 30 June 1983 and that it has not been formed by splitting up or reconstruction or reconstitution of an existing business or by transfer to a new business of any plant or machinery already used in an existing business. This concession applies in respect of assessment years ending on 30 June 1985.[34]

5. Accelerated depreciation

In addition to the normal depreciation allowance on plant and machinery installed by an industrial undertaking, certain special measures have been adopted during the period from 1970 onwards to depreciate the capital assets over a relatively short period of time. These measures were intended to ease the cash flow position of the companies engaged in industrial undertakings. These measures include:

(i) Initial depreciation allowance of 25% on plant and machinery installed between July 1976 and June 1983.[35]

(ii) Rate of initial depreciation in case of industrial undertakings commencing commercial production on or after 1 July 1981 admissible at 40% as against the earlier rate of 25%.

(iii) Depreciation allowance of 10% in respect of residential buildings for industrial labour. Initial depreciation allowance of 25% admissible on buildings constructed up to 30 June 1983 for industrial labour earning up to 1,000 Rs. per month.

6. Other investment related incentives

Apart from the specific income tax incentives discussed above, various other investment related incentive programs have also been introduced during the period from 1970-71 onwards. These include:

(i) The amount required to be distributed as dividends by tax holiday companies (under S. 15BB of the repealed Income Tax Act, 1922) was lowered from

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30. See Section 15FF of the repealed Income Tax Act, 1922 and Section 106 of Income Tax Ordinance, 1979.
The BMR concession was for the first time introduced through the Finance Ordinance, 1976 (by introducing S.15GG in the repealed Income Tax Act, 1922) at 10% of the amount invested in the purchase of plant and machinery and it was applicable up to 30 June 1979. The rate of tax credit was raised to 15% through the supplementary Finance Ordinance 1977, and the period of admissibility was extended to 30 June 1980 by virtue of the Finance Ordinance, 1978.

31. During FY 1978-79, the BMR concession was supplemented by exempting dividends paid by public companies incorporated between 1 July 1978 and 30 June 1982 and engaged in an industrial undertaking set up during this period for a period of 5 years from the year in which commercial production commenced (S.4(3)(xv)(4) of the repealed Income Tax Act, 1922).

32. See Section 105-A of the Income Tax Ordinance, 1979.

33. See Section 48 of the Income Tax Ordinance, 1979. The Finance Ordinance 1975 provided that this tax concession would be available for 5 years, i.e. 1 July 1975 to 30 June 1980 at the rate of 10% of capital, if the undertaking was set up in Baluchistan, Tribal Areas, Northern Areas and Azad Kashmir, and at 5% if it were located elsewhere (excluding Talukas of Karachi and Hyderabad and Tehsil Lyallpur and Lahore and adjoining areas of Tehsil Lahore as notified by the Federal Government through amendment in S.15B of the repealed Income Tax Act, 1922. The exemption was restricted to companies other than those formed by splitting up, reconstitution or reconstruction by virtue of the Finance Ordinance, 1976. The rate of the investment credit for areas other than Baluchistan, Tribal Areas, etc. was raised from 5% to 10% by virtue of the Finance Ordinance, 1979. The tax exemption which expired on 30 June 1981 was also extended to 30 June 1983 through the same Finance Ordinance.

34. This measure was adopted through the Finance Ordinance 1975 by amending Section 10(2) (V a) – Explanation 2.

35. In addition to the type of depreciation allowance described above, a special depreciation of 15% was also admissible to industries set up by 30 June 1980. The condition of two consecutive months use of plant and machinery for claiming depreciation has also been removed through the Finance Ordinance 1980.

60% to 50% (and consequently the extent of reserves to be compulsorily retained raised from 40% to 50%) (during fiscal year 1970-71).

(ii) Tax on undistributed profits of companies was withdrawn (during fiscal year 1972-73).

(iii) To reduce the adverse effects of fluctuation in exchange rates, the Government allowed an adjustment in the rate of the written-down value of plant and machinery acquired through foreign loans with effect from 1975 (during the fiscal year 1978-79).

(iv) Listed holding companies were allowed to set off current losses of a wholly owned subsidiary company against current year's income for a period of 3 years with effect from assessment year 1981-82 provided that the holding company gives a scheme of revival of the sick mill* duly approved by a financial institution, namely, PICIC, IDBP, NDFC or Banker's Equity Ltd.[36]

(v) While computing taxable profits, Pakistani companies exporting carpets and engineering goods have been allowed a deduction of expenditure on account of publicity and free samples abroad at the rate of 3½ times of the actual expenditure by virtue of the Finance Ordinance, 1981.

(vi) In order to reduce the cost of technical expertise from abroad, as required for industrial projects, the income of expatriate technicians has historically been exempted from income tax for the initial period of 3 years, and exempt from payment of tax-on-tax during the subsequent 3 years if the employing enterprise pays the tax on behalf of such a person.

(vii) With a view to attracting foreign investment, a liberal tax exemption has been granted to approved foreign loans.

(viii) A tax holiday has been granted to industries set up in the Export Processing Zone to the extent that:
   (a) income of the enterprise and of foreign employees is exempt from income tax for a period of 5 years, extendable by the Federal Government in the light of performance of the enterprise;
   (b) a concessional rate of tax will be applicable at ¼ the prevalent tax rate for a period of 5 years after the expiry of the full tax holiday period;
   (c) capital gains out of sale proceeds and shares of such enterprises are exempt from income tax.

In the light of the preceding paragraphs it can be safely stated that the government made a conscious attempt to provide liberal income tax incentives for accelerating the process of industrial development both in the already developed and "pre-industrial" regions of Pakistan. As to the adequacy or otherwise of these incentive programs, and their actual impact in accelerating the process of industrialization in the country, the following sections indicate actual performance.

D. Evaluation of the impact of income tax incentives on the pace of industrial development in Pakistan

The plan strategy for industrial development in Pakistan necessitated the introduction of various fiscal concessions. These were supplemented by non-fiscal and monetary measures such as providing infrastructural facilities, skilled manpower, advisory services, credit facilities, etc. The fiscal measures included exemptions (partial as well as total) from income tax, sales tax and customs duties. In the absence of economic data, it is not possible to identify the impact of individual measures through carrying out a regression analysis. As such, the following analysis regarding the impact of the income tax concessions with respect to the pace of industrial development during the decade of 1970-80 can merely serve as an indicator and any conclusions may be treated as the best approximation. This is especially true as factors like marketability or market share of industrial products, profit margins, etc. have not been accounted for.

Before actually embarking upon the evaluation of income tax concessions it seems appropriate to refer briefly to the customs duty concessions, as prevailing during the period under reference, due to the fact that they partially fit in the package of fiscal measures for developing the "pre-industrial" geographical regions of Pakistan. Further, considering the huge capital outlays for the industrial projects, partial or total exemption from customs duties on import of plant and machinery plays a vital role in making investment decisions. As to the customs duties, under-developed areas were extended total exemption on import of plant and machinery.[37] Relatively less developed areas were granted a 50% concession on duty on import of plant and machinery.[38] Similarly, plant and machinery for industrial units located in industrial estates in areas outside the geographical regions covered by the 50% concession attracted only a 10% rate of duty. Nevertheless, total exemption from customs duties was granted on import of plant and machinery for installation in the industrial estates in specified under-developed areas.[39] Selective concessions in duties were also granted on the basis of category of industry.[40]

It is, thus, obvious that whereas total exemption from customs duty is available on the import of plant and machinery for industrial establishment enjoying income tax concessions under Clauses 119, 120, 121 and 122 of Part I of the Second Schedule to the Income Tax Ordinance, 1979, the entire tax holiday area covered under Section 15B of the repealed Income Tax Act 1922[41] was

* *Editors note:* sick industry.

36. See Section 34 A of the repealed Income Tax Act, 1922. This measure was adopted during FY 1980-81 so as to revive sick mills.

37. Total exemption from customs duty was granted through S.R.O.695(I)/77, dated 4 August 1977 as amended through S.R.O.22(I)/78, dated 1 January 1978 to the Province of Baluchistan, D.I. Khan & Malakand Division, Mansehra & Kohistan District, Tribal Areas, Northern Areas, and Azad Kashmir.

38. A concession to Government-financed industrial estates at Karachi and whole of Pakistan, excepting certain industrially developed districts, was granted through S.R.O.1481(I)/74 dated 4 December 1974.

39. The geographical regions attracting no duty include N.W.F.P. Districts D.G. Khan, Mianwali, and Tehsil of Khushab, Districts Shikarpur, Jacobabad and Dadu excluding Kotri.

40. This includes machinery for balancing, modernization and replacement of textile, tanning, cutlery, surgical goods, sports goods, leather garment and gloves, and garment manufacturing industries. Shoe manufacturing and hosiery industries, poultry and dairy farming and establishment of fertilizer units were later included in the list of such industries through S.R.O.829(I)/78 dated 20 June 1978, SRO.830(I)/78 dated 29 June 1978, and SRO.393(I)/74 dated 21 March 1978 respectively.

41. Section 15B of the repealed Income Tax Act, 1922 provided an investment credit to the new industrial undertaking.

not extended the 50% concession in customs duties. Similarly, the concession in duty on import of plant and machinery for balancing, modernization and replacement (which enjoys a general income tax credit under Section 107 of the Income Tax Ordinance 1979) has been restricted only to a small group of industries. Further, the distinction in the rate of duty on plant and machinery imported under the "Repatriable and Non-repatriable Investment Scheme (NRI)" does not squarely fit in the overall package of income tax concessions granted to new industrial establishments. The sum total of the above discussion is that we can safely presume that due to the almost simultaneous existence of both income tax and customs duty concessions designed for dispersal of industries to the "pre-industrial" or less-developed geographical regions, the final conclusions reached through evaluating the role of the income tax incentives is not tangibly affected by not specifically taking into consideration the effect of customs duty concessions.

Against the above background, it is now easier to see through the overall industrial performance during the decade 1970-80 and spell out the effect of the income tax incentives on the pace of industrial development. The performance of the industrial sector in the Third Plan, though substantial, was not entirely up to expectations. The Plan has had a chequered career. It got off to a difficult start in FY 1965/66 and the pace of investment and production was again upset by the disturbances of FY 1968/69. The investments sanctioned for large, medium and small scale industries in the private sector between July 1965 and December 1969, both under CIIS and PLI amounted to 5,877 million Rs. (as against the Plan target of 9,287 million Rs.).

Phenomenal growth of public sector investment

Private sector industrial investments (in current prices) during FY 1969-70, 1970/71 and 1971/72, respectively, stand at 1,395.9 million Rs., 1,425.7 million Rs. and 1,235.4 million Rs. as against public sector investment of 179.2 million Rs., 69.2 million Rs. and 98.5 million Rs. during the same period. There was a fall in the private industrial investment during FY 1972/73 and 1973/74, i.e. 1,019 million Rs. and 1,022.8 million Rs. respectively. Subsequently, it reached 2,111 million Rs. during FY 1976/77 and 3,808 million Rs. in FY 1980/81. The growth in public sector investment during FY 1973/74 onwards was, however, phenomenal. It started from a very low level of 110.6 million Rs. during FY 1972/73 and touched 6,315.5 million Rs. during FY 1980/81. The average public sector investment during this period has varied between 10 and 60 times the investment during FY 1972-73.[42] Nevertheless, in spite of the entire emphasis on the public sector up to the year 1974/75, the growth in private sector investment has been on the increase (in current prices) which is to be attributed to the overall economic strategy including a package of fiscal incentives.

Impact of tax incentives on industrialization

While compiling the necessary statistical data to form the basis of evaluation, it has been observed that no consolidated data on a uniform pattern are available for the purposes of the present study.[43] Therefore, the consolidated data from the Annual Report of the State Bank of Pakistan and the Industrial Profile of the N.W.F.P., along with some other scattered information, form the basis of the present analysis. For the purposes of convenience, the N.W.F.P., which is relatively a less-developed geographical region, forms the focus of the present evaluation. Consequently, the analysis suffers from quite a few inadequacies and may be treated as the best approximation.

Appendix II shows the comprehensive picture of all Pakistan-based industrial investment, in both the private and public sectors. It appears that during the period FY 1972/73 to FY 1980/81, total industrial investment stands at 227,179 million Rs. out of which the share of private investment works out at 71,935 million Rs. The investment made in large scale and small scale manufacturing is reported at 18,678 million Rs. The N.W.F.P. attracted private investment to the tune of 1,267.33 million Rs. The all Pakistan investment pattern over FY 1972/73 – FY 1980/81 indicates a gradual increase in the private sector investment over the years. Nevertheless, during FY 1979/80 and 1980/81, there has been a greater buoyancy in favour of investment which respectively touched the figure of 2,995 million Rs. and 3,808 million Rs. The N.W.F.P. recorded the lowest investment of 1.194 million Rs. during the start of the period under reference, i.e. FY 1972/73 (Appendix III). It increased to 118.273 million Rs. during FY 1973-74. FY 1976-77 observed the record high investment of 402.086 million Rs. which again showed a decline during the subsequent period.[44] As to the number of industrial units established from 1972/73 onwards, the number gradually increased from 3 in FY 1972/73 to 28 in FY 1976/77 (the year indicating the highest investment). There is a gradual decline thence onward and only 18 industrial units were established during FY 1980/81.

As to public sector investment during the same period in N.W.F.P., it has been observed that out of the total public sector investment of 155,244 million Rs. N.W.F.P. got a share of 51,125 million Rs. for industries and mineral sectors. As to the total number of units, a total of 58 industrial units were established by various agencies including Sarhad Development Authority, Small Industries Development Board, and FATA Development Corporation during FY 1972/73 onwards. The total investment in these units stands at 855.552 million Rs. (in-

42. Source: Ministry of Finance and Economic Affairs.
43. The economic data on the industrial sector is reflected through the various Government publications which include Census of Manufacturing Industries (CMI), Economic Survey, Pakistan – Basic Facts, Pakistan Statistical yearbook, monthly publications of the Industries Developments, Annual Report of the State Bank of Pakistan, etc. The CMI is available only up to the period 1970-75. It is not possible to derive a uniform data pattern out of these publications on the required lines.
44. Industrial Profile of The N.W.F.P., Industries, Commerce, Labour, Mineral Development and Transport Development, p. 63.

cluding 4.642 million Rs. spent in establishing 7 industrial estates during this period). The Federal Government (through various corporations) established 16 capital-intensive industrial units (cost of these projects is not available). The district-wise position of various projects established from FY 1972/73 to FY 1980/81 is reflected in the table below:

District	Number of units established	Cost incurred Rs.
Peshawar	12	339.118 million
Mardan	8	200.239 million
Kohat	5	4.782 million
D.I. Khan	6	32.930 million
Abbottabad	15	155.665 million
Mansehra	4	1.143 million
Bannu	4	16.444 million
Swat	7	45.010 million
Dir	1	0.146 million
Chitral	2	0.315 million

The employment generated by the 16 projects of Sarhad Development Authority and 9 FATA Development Corporation projects shows an average of 145.52 persons per project.[45]

The statistics indicate the total number of operating units in N.W.F.P. at 335 at the end of FY 1980/81. The majority of these units are located at Peshawar, Mardan, Swat and Abbottabad (i.e the already industrially developed districts). The districts of Kohat, Bannu, D.I. Khan, Malakand Agency and Mansehra respectively have 8, 8, 7, 7 and 6 units.[46]. The relatively detailed analysis indicates that as against a total number of 828 NOCs (No Objection Certificates) for establishing industrial units between FY 1970/71 and FY 1980/81, a total of 82 units were actually established. Whereas the number of units established from FY 1974/75 to FY 1978/79 stands at an average of 11 units, the highest number of units, i.e. 19, was established during FY 1979/80. Most of these units were established in the districts of Peshawar, Mardan, Hazara, and Swat, i.e. 38, 11, 11 and 15 respectively. The number of units established in the districts of Bannu, Kohat and D.I. Khan stands at 2, 8 and 3 respectively.[47]

As to the district-wise investment approved by the financial institution from FY 1969/70 to FY 1980/81, statistics indicate that out of the total approved investment of 801.3055 million Rs., the highest investment was observed during FY 1979/80, i.e. 132.0815 million Rs. for 24 cases. Except for FY 1970/71 which recorded the lowest investment approvals, i.e. 12.6 milion Rs. for 8 cases, the trend of investments approved showed a gradual increase from FY 1971/72 to FY 1975/76. There was a decline in the investments during FY 1976/77 after which a gradual increase was registered, reaching the highest during FY 1979/80. The investments approved during FY 1980/81 stand at 110.844 million Rs.[48]

Regarding the district-wise investment approvals during the same period, the Peshawar district received the highest amount of approved investment, i.e. 229.9285 Rs. The districts of Abbottabad and Mardan stand almost equal, i.e. 169.517 million Rs. and 165.884 million Rs. respectively, the districts of Kohat, Bannu, D.I. Khan and Mansehra received investment approvals varying from 40 million Rs. to 69 million Rs. The lowest investment was recorded in the Malakand Agency and Swat Division, i.e. at 26.00 and 25.195 million Rs. There was no investment at all in the districts of Kohistan, Dir and Chitral.

The analysis in regard to the private sector industrial units established in the Small Industrial Estates at Peshawar, D.I. Khan, Abbottabad, Swat, Mardan, Kohat and Bannu districts indicates that since the inspection of these industrial estates (mostly during early and mid-1970), the maximum number of plots was allotted at Peshawar, i.e. 1962. The next highest number of plots was allotted in the district of Mardan. The number of plots allotted in the industrial estates in D.I. Khan, Abbottabad, and Bannu district up to FY 1980/81 is relatively low, i.e. varying from 14 to 29. No plots were allotted in the Industrial Estates in Swat and Kohat district despite the availability of 131 plots in the latter district.[49]

The above analysis is summed up as follows:

(i) As against all Pakistan private investment of 18,678 million Rs. from FY 1972/73 to FY 1980/81, N.W.F.P.'s share is at 1267.33 million Rs. The N.W.F.P. public sector allocation for industries and mineral sector during the same period is reported at 5,1125 million Rs.

(ii) As against the total picture of 335 industrial units employing 49,452 persons as at the end of FY 1980/81, private sector industrial units starting operations between FYs 1970/71 and 1980/81 stands at 182 units (with a total capital investment of 1,691.611 million Rs. and employing 14,883 persons). During the same period 58 industrial units, with an investment of 855.22 million Rs. were established in the public sector. The position of loans approved in respect of the private sector from the FY 1969-70 to FY 1980-81 stands at 801.3055 million Rs. The district-wise position indicates that out of these units, the highest number of units was established in the Peshawar district, i.e. 82 units (with an investment of 504.299 million Rs.).The Mardan and Swat districts followed with 36 units (investment of 485.969 million Rs.) and 21 units investment of 62.126 million Rs. The Abbottabad district which attracted 16 industrial units from FY 1970/71 to FY 1980/81 had a total investment of 80.3347 million Rs.

(iii) Private industrial investment was lowest in FY 1972, i.e. 1.194 million Rs. as against the highest recorded investment at 402.086 million Rs. during FY 1976/77. There was a gradual decline in the subsequent years (except 1979/80 which showed an investment higher than the preceding as well as succeeding years).

(iv) The majority of the 335 industrial units operating at the end of FY 1980/81, were established at the Peshawar, Mardan, Swat and Abbottabad districts (i.e. 181, 46, 51 and 28 respectively).

The analysis indicates that despite very liberal tax incentives, the investment, both in terms of financial investment and number of units, converged on the already developed districts, i.e. Peshawar, Mardan, and Abbot-

45. Ibid., p. 65.
46. Ibid., p. 49.
47. Ibid., pp. 80-94, 64-65.
48. Ibid., p. 63.
49. Ibid., Table 11, p. 48.

tabad. Nevertheless, the trend of industrial development in the other districts, i.e. Kohat, Bannu, D.I. Khan and Swat, indicates that investment started flowing to these areas only during the tax holiday period. The Kohat district recorded the lowest investment from FY 1973/74 to FY 1975/76, and FY 1980/81. No investment was made at all from FY 1976/77 to 1978/79 (which can probably be attributed to the relatively adverse political situation in the area). The investment in the Bannu district since FY 1971/72 has been more or less constant. The districts of Kohistan, Dir and Chitral (the areas with practically no infrastructural facilities) did not attract any investment at all.

Conclusions

The above analysis leads to the following conclusions:

(i) The overall level of industrial investment between FY 1970/71 and FY 1980/81 has been encouraging. However, the major investment appears to have been made in the public sector rather than the private sector.

(ii) Private sector investment was relatively lower between FY 1970/71 and FY 1974/75 (a period having few income tax concessions). It gradually started increasing with the introduction of income tax incentive programs during FY 1975/76, and during FY 1980/81 it touched a level four times higher than that during FY 1970/71. Thus, increased investment, apart from a variety of other factors such as economic stability, Government's changed emphasis on private investment, etc., can be attributed to tax concessions.

(iii) Whereas public sector investment has gone to all kinds of geographical regions, both pre-industrial and fully developed, private sector investment has been selective. It has essentially converged on these geographical areas with the necessary infrastructural facilities, market share, etc. Wherever such facilities were not available (which includes Dir, Chitral and Kohistan districts in the N.W.F.P.), either a too low investment or no investment at all was made. The pre-tax or post-tax profits (due to the availability or otherwise of the tax concessions) seem to have had no impact while making the investment decisions in the various geographical regions.

(iv) The overall Government policy regarding the role of private investment, the uncertainty in its economic policies and the political situation prevailing during a particular period of time governed the level of industrial investment. Thus, although tax incentive legislation was introduced from FY 1974/75 onwards, the level of investment remained almost constant from FY 1975/76 to FY 1978/79, essentially due to uncertain Government policies towards private investment. The moment that the credibility gap was to some extent bridged, there was a phenomenal increase in industrial investment from a figure of 2,293 million Rs. in FY 1978/79 to 2,995 million Rs. and 3,808 million Rs. in FY 1979/80 and FY 1980/81 respectively.

(v) Income tax incentive legislation played a vital role in inducing private sector investment in the areas where infrastructural facilities were in existence. This is indicated by the high level of investment in the districts of Peshawar, Mardan and Abbottabad in the N.W.F.P. between FY 1970/71 and FY 1980/81. The same is true in respect of the other tax holiday areas adjoining the developed regions of the other provinces.

(vi) As a result of the industrial investment motivated by the liberal tax concession, additional employment to the tune of 14,883 was created from FY 1970/71 to FY 1980/81 in the N.W.F.P. alone. The total number of industrial employment places stood at 49,452 at the end of FY 1980/81. The indicators show that whereas the capital intensive public sector projects generated relatively less job opportunities, private sector investment was essentially labour-oriented.

(vii) Regarding the improvement in industrial production, the overall country-wise manufacturing sector indices (Appendix IV) (in constant 1969/70 prices) stand at 104, 104, 101, 112, 115 and 127 respectively for FY 1974/75 through FY 1979/80.[50] The major portion of the value of production during FY 1975/76, i.e. approximately 47%, relates to textile and food manufacture. The trend continued during subsequent years. These industries, along with other manufacturing industries of the private sector, have been the major contributors to the overall value of production. The manufacturing sector indices indicate the level of increase in production over the period FY 1974/75 through FY 1979/80. The fiscal incentives had their role in increased production through encouraging new investment and balancing, modernization and replacement of existing industrial units.

(viii) The export oriented tax concessions can be referred to as having played an important role in the overall economic strategy for establishing industries aiming at the exports of manufactured products. The quantum of exports of manufactured goods increased from 1,998.4 millions Rs. in FY 1970/71 to 10,286.3 million Rs. in FY 1974/75, touching the figure of 21,393.9 million Rs. in FY 1980/81, showing an increase of 100% (in current prices) during the decade of 1970/71 – 1980/81. The ratio of exports of semi-manufactured and manufactured goods to exports of primary commodities during the period from 1975/76 to 1980/81 (the period of liberal tax concessions) has generally been around 3:2.[51] (Appendices V and VI).

(ix) As to the role of tax incentives in developing import substitution industries, nothing can be said with certainty, especially in view of the fact that importation of all kinds of goods including consumer goods, raw material for consumer goods, capital goods and raw material for capital goods has been constantly on the increase from FY 1975/76 through 1980/81. The quantum of imports (in current prices) increased from 20,672 million Rs. in FY 1975/76 to 49,809 million Rs. in FY 1980/81. The intervening period shows

50. Ministry of Finance & Economic Affairs.
51. Statistics Division, Ministry of Planning and Development.
52. Ibid.

a gradual increase except FY 1979/80 which reflected a decline of 4,869 million Rs. as compared with the immediately preceding year. The ratio of imports of consumer goods to capital goods during the period under reference has generally been around 3:2.[52]

To sum up the discussion, the available information about the N.W.F.P. (without pro-rating it to the rest of the country) indicates a favourable impact of tax incentive legislation over the industrial investment, provided infrastructural facilities existed in the tax holiday area.

The overall level of private investment in Pakistan in the manufacturing sector showed a favourable increase over the years 1970/71 – 1980/81. The extent to which it was influenced by the fiscal measures is a question of value judgement and cannot be stated with certainty. However, keeping in view the constant public demand for all kinds of tax concessions as a means of inducing investors, it can be safely stated that investment would not have been attracted to the given level without providing the necessary income tax concessions. The positive role of tax incentives is, thus, implicitly established.

APPENDIX I

Statement of industrial tax incentives

S.No.	*Type of tax concession*		*Brief description*	*Duration of tax concession*	*Expiring on*
1.	*2.*		*3.*	*4.*	*5.*
	Tax holidays				
1.	Area-wise tax holidays	(i)	Total tax exemption for industries set up in Baluchistan during the period from 1 July 1978 to 30 June 1983 (Clause 80 of Part I of the Second Schedule).	5 years	30.6.83
		(ii)	Total tax exemption for industries set up in D.I. Khan and Malakand division from 1 April 1978 to 30 June 1983 (Clause 81 of Part I of the Second Schedule).	5 years	30.6.83
		(iii)	Total tax exemption for industries set up in Tribal Areas, districts of Mansehra and Kohistan from 1 July 1979 to 30 June 1983 (Clause 82 of Part I of the Second Schedule).	5 years	30.6.83
		(iv)	Total tax exemption for industries set up in approved industries estates in N.W.F.P., D.G. Khan, Mianwali, Tehsil Khushab, Dadu (excluding Kotri), Jacobabad and Shikarpur (Clause 82A of Part 2 of the Second Schedule).	5 years from date of setting up	–
	Income-wise tax holidays	(i)	Total exemption of the dividends received from public companies from 1 July 1978 to 30 June 1982 (Clause 80 of Part I of the Second Schedule)	5 years	30.6.82
		(ii)	Dividends paid by a company wholly owned by a foreign Government (Clause 82 of Part I of the Second Schedule)		
		(iii)	Dividend income of an approved private company engaged in planning, promoting, developing, organizing and implementing schemes for establishing industrial, commercial mining, etc. (Clause 81 of Part I of the Second Schedule).	10 years	
		(iv)	Bonus shares issued by a company or body corporate between 1 September 1977 and 30 July 1982 (Clause 108 of Part I of the Second Schedule).	5 years	30.6.82
		(v)	Capital gains on disposal of shares of public companies, etc.		
	Sector-wise tax holidays	(i)	Total exemption of manufacture of agricultural implements to industries set up to 30 June 1983 (Clause 98 of Part I of the Second Schedule).		30.6.83
		(ii)	Total exemption of income from sale and renting of agricultural machinery or provision of pet control as set up from 1 July 1976 to 30 June 1983 (Clause 96 of Part I of the Second Schedule).	2 years	30.6.83
		(iii)	Income from poultry farming, fish catching, cattle sheep breeding tax exempt during the period up to 30 June 1983 (Clause 99 of Part I of the Second Schedule).	–	30.6.83
		(iv)	Income from poultry processing tax exempt between 1 July 1980 and 30 June 1983 (Clause 100 of Part I of the Second Schedule).	3 years	30.6.83
		(v)	Income from dairy farming up to 30 June 1983 (Clause 101 of Part I of the Second Schedule).		
		(vi)	Income of cooperatives (Clause 103 of Part I of the Second Schedule).	–	–
		(vii)	Income from garment industry exempt as set up during 1 July 1978 to 30 June 1983 (Clause 125 of Part I of the Second Schedule).	5 years	30.6.83
		(viii)	Income from date processing, manufacture of chipboard/strawboard and refining of edible oil of industries set up from 1 May 1978 to 30 June 1983 in Sukkur district for 5 years (Clause 124 of Part I of the Second Schedule).	5 years	30.6.83

S.No.	Type of tax concession		Brief description	Duration of tax concession	Expiring on
1.	2.		3.	4.	5.
		(ix)	Income of mineral industries exempt in respect of industries set up from 1 July 1981 to 30 June 1985 for 5 years) (Clause 123 of Part I of the Second Schedule).	5 years	30.6.83
2.	Tax rebates	(i)	5% rebate on super tax to industries set up between 1 July 1975 and 30 June 1983. (First Schedule of the Income Tax Ordinance 1979).	8 years	30.6.83
		(ii)	Tax rebate of 55% on export business (First Schedule to the Income Tax Ordinance 1979).	–	–
3.	Tax credit		BMR concession to industries during the period 1 July 1976 to 30 June 1983 (Section 107 of the Income Tax Ordinance, 1979)	9 years	30.6.83
4.	Investment credit		Concession to industries set up from 1 July 1975 to 30 June 1983. (Section 48 of the Income Tax Ordinance, 1979).	8 years	30.6.83

APPENDIX II

Investment (million Rupees)

S.No.	Year	Investment at current prices			Private investment by economic activity (at current prices)										
		Public sector	Private sector	Gross fixed investment (3) + (4)	Agriculture	Mining & quarrying	Manufacturing			Construction	Electricity & gas	Transport & communication	Banking, insurance & fin. insts.	Ownership of dwellings	Services
							Total	Large scale	Small scale						
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
1.	1972-73	3,921	3,726	7,647	612	19	1,019	763	256	24	112	968	35	496	444
2.	1973-74	6,774	3,840	10,614	738	23	1,023	697	326	27	1	1,000	10	500	519
3.	1974-75	11,010	5,208	16,218	846	30	1,437	990	447	62	1	1,016	6	1,136	673
4.	1975-76	16,286	6,484	22,770	1,349	33	1,819	1,309	510	50	2	1,071	7	1,341	813
5.	1976-77	18,641	7,780	26,421	1,600	37	2,111	1,525	585	119	2	1,167	14	1,709	1,021
6.	1977-78	20,213	8,763	28,976	1,947	40	2,173	1,539	634	105	2	1,227	13	2,035	1,221
7.	1978-79R	21,871	9,556	31,427	2,064	44	2,293	1,569	724	118	2	1,384	17	2,273	1,359
8.	1979-80R	26,834	12,441	39,275	2,465	49	2,995	2,177	818	97	2	2,100	26	3,003	1,703
9.	1980-81R	29,694	14,135	43,829	2,757	53	3,808	2,832	976	123	5	1,712	12	3,777	1,887

Source: Annual Report 1980-81
Table II. 2, II. 3
State Bank of Pakistan

APPENDIX III

Statement of industrial investment in N.W.F.P. (private sector)

Units starting operation from 1970-71 tot 1980-81

Fiscal years	No. of units	Investment (in million Rs.)	Employment
1970-71	13	104.466	1,194
1971-72	10	319.839	1,599
1972-73	3	1.194	112
1973-74	12	118.273	1,642
1974-75	16	85.392	779
1975-76	19	16.565	708
1976-77	28	402.086	3,219
1977-78	26	178.820	1,670
1978-79	20	70.510	630
1979-80	17	252.950	1,815
1980-81	18	141.540	511
Total:	182	1,691.611	14,883

APPENDIX IV

Pakistan: Manufacturing sector indices, 1974/75 - 1980/81

(1972/73 = 100)

	1974/1975	1975/1976	1976/1977	1977/1978	1978/1979	1979/[1] 1980
Manufacturing output)in constant 1969/70 prices)	104	104	101	112	115	127
Manufacturing employment	115	118	122	126	129	133
Output per man (at constant 1969/70 prices)	91	88	83	89	89	94
Manufactured exports[2] (in current dollars)	103	122	129	161	221	235

Source: Ministry of Finance and Economic Affairs.

1. Provisional.
2. Includes exports of semimanufactures.

APPENDIX V
Major exports

S.No.	Items	1970-71	1971-72	1972-73	1973-74	1974-75	1975-76	1976-77	1977-78	1978-79	1979-80 July-March	1980-81
1.	2	3	4	5	6	7	8	9	10	11	12	13
1.	Fish and fish preparations	61.3	111.1	233.7	276.0	156.5	278.8	381.3	341.4	461.9	530.5	530.9
2.	Rice	173.0	274.1	1136.1	2098.4	2303.7	2479.1	2477.9	2408.5	3380.0	4179.3	3846.1
3.	Hides and Skins	16.7	19.6	16.9	23.5	46.1	30.4	2.3	–	–	–	–
4.	Raw wool	20.9	24.6	82.8	64.1	20.3	66.2	76.2	72.8	100.2	94.6	30.2
5.	Raw cotton	270.0	954.8	1167.0	367.1	1543.9	980.5	292.1	1101.8	655.2	3321.0	4462.0
6	Cotton waste	14.8	27.4	31.4	35.0	18.6	10.4	23.7	16.1	14.6	18.6	13.0
7.	Leather	107.0	173.5	544.9	418.5	367.3	595.9	647.4	636.5	1247.0	1264.0	621.3
8.	Cotton yarn	344.2	592.3	1941.0	1810.6	851.4	1427.3	1171.7	1059.5	1956.1	2038.0	1465.1
9.	Cotton thread	12.8	13.4	33.3	52.5	57.4	39.5	43.4	70.7	57.7	70.1	67.0
10.	Cotton cloth	311.3	387.1	1247.1	1416.8	1312.5	1359.4	1603.3	1741.2	2135.2	2416.0	1711.1
11.	Petroleum and products	38.6	41.3	128.6	175.6	138.5	192.0	268.5	625.9	607.9	1764.2	1319.4
12.	Synthetic textiles	14.8	12.2	57.3	65.3	22.5	34.3	35.3	154.0	64.6	54.3	903.6
13.	Footwear	29.4	38.9	83.6	94.5	125.5	66.0	89.3	71.6	96.7	105.8	75.8
14.	Animal casings	8.3	9.5	21.2	29.1	21.2	35.1	33.0	26.4	31.1	41.1	42.3
15.	Cement and products	20.5	43.9	106.2	167.2	279.5	50.9	5.6	3.2	–	–	–
16.	Guar products	39.6	39.2	95.7	175.7	163.7	196.9	181.7	202.6	271.7	332.6	198.9
17.	Oil cakes	6.2	3.4	78.8	7.8	0.2	0.3	1.8	98.9	71.5	41.4	30.8
18.	Paints and varnishes	3.8	4.7	5.3	6.0	6.9	8.2	9.7	7.6	8.0	8.5	7.7
19.	Tobacco, raw and manufactured	14.4	25.3	49.0	107.2	132.6	160.2	163.8	126.1	100.8	80.6	41.7
20.	Readymade garments, hosiery	29.9	35.9	97.4	167.4	244.9	328.4	417.7	138.7	376.6	731.2	652.2
21.	Drugs and chemicals	11.9	10.9	37.0	102.8	116.3	133.3	134.3	146.3	131.0	122.2	102.9
22.	Surgical instruments	18.4	22.5	45.2	85.2	129.4	131.4	133.8	160.5	210.8	240.2	182.4
23.	Carpets and rugs	64.7	198.7	281.5	457.7	456.0	719.2	911.7	1170.8	1764.7	2198.4	1718.7
24.	Sport goods	32.7	50.7	136.0	188.0	204.5	189.2	199.1	194.9	212.1	244.6	216.9
25.	Others	338.2	346.4	894.2	1770.2	1566.9	1745.0	1988.9	2404.4	2969.6	3512.5	3255.9
	GRAND TOTAL	1998.4	3371.4	85551.2	10161.2	10286.3	11252.9	11293.9	12980.4	16925.0	23410.1	21395.9

Source: Pakistan Economic Survey 1980-81.

APPENDIX VI
Pakistan: Exports and imports by economic categories, 1975/76 - 1980/81[1]

	1975/76	1976/77	1977/78	1978/79	1979/1980	1979/80	1980/81
			I. Exports (in millions of U.S. dollars)				
Primary commodities	495.2	466.9	468.1	552.9	993.8	940.0	1,203.0
Semi-manufactured goods	208.8	190.7	193.1	352.4	355.5	328.5	305.7
Manufactured goods	432.6	483.2	650.0	804.3	1,015.4	901.8	1,162.3
Total	1,136.6	1,140.8	1,311.2	1,709.6	2,364.7	2,170.3	2,671.0
			(%)				
Primary commodities	43.6	40.9	35.7	32.3	42.0	43.3	45.0
Semi-manufactured goods	18.4	16.7	14.7	20.6	15.0	15.1	11.5
Manufactured goods	38.0	42.4	49.6	47.1	43.0	41.6	43.5
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
			II. Imports[2] (in millions of U.S. dollars)				
Consumer goods	438.0	368.8	561.1	792.1	757.6	679.3	705.8
Raw materials for consumer goods	778.8	924.0	1,113.5	1,557.2	2,003.5	1,839.3	2,492.6
Raw material for capital goods	127.4	147.8	194.0	218.2	294.5	275.0	362.9
Capital goods	723.0	883.9	941.0	1,108.1	1,684.7	1,463.8	1,419.6
Total	2,067.2	2,324.5	2,809.6	3,675.6	4,740.3	4,253.4	4,980.9
			(%)				
Consumer goods	21.2	15.9	20.0	21.6	16.0	16.0	14.2
Raw materials for consumer goods	37.7	39.7	39.6	42.4	42.3	43.1	50.0
Raw materials for capital goods	6.1	6.4	6.9	5.9	6.2	6.5	7.3
Capital goods	35.0	38.0	33.5	30.1	35.5	34.4	28.5
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Statistics Division, Ministry of Planning and Development.

1. Customs data, which differ from balance of payments due to differences in timing, coverage, and valuation.
2. On a mixed c. and f. basis.

PAKISTAN:

INCENTIVES FOR INVESTMENT IN INDUSTRIAL PROJECTS *

Incentives/concessions provided to the investors

A. Custom duty exemption:

(1) Complete exemption from custom duty if project is located in:
The Province of Baluchistan,
Territory of Azad Kashmir,
Northern Areas and Tribal Areas,
Dera Ismail Khan and Malakand Divisions,
Mansehra and Kohistan Districts and approved Industrial Estates of N.W.F.P.,
Approved Industrial Estates in the Districts of Shikarpur, Jacobabad and Dadu excluding Kotri in the Province of Sind, and
Approved Industrial Estates in Districts of Dera Ghazi Khan and Mianwali and Tehsil Khushab in the Province of Punjab.

(2) Complete exemption from custom duty on such items of machinery as are not manufactured in the country for the industries relating to:
Fertilizer, readymade garments, poultry industry, and dairy industry.

(3) Complete exemption from custom duty on such items of imported machinery as are not manufactured in the country for balancing, modernisation and replacement in industries relating to:
Textile, tanning, cutlery, surgical goods, sports goods, and leather garments and gloves.

(4) 50% exemption in custom duty for specified under-developed areas as detailed below:

i) All Government financed industrial estates except those located at Karachi.
ii) The whole of Pakistan excluding the areas specified below:
    1) Tehsil of Rahimyar Khan
    2) Tehsil of Multan
    3) Tehsil of Faisalabad
    4) Tehsil of Shahdra
    5) Tehsil of Lahore
    6) Tehsil of Gujranwala
    7) Tehsil of Sialkot
    8) Tehsil of Rawalpindi
    9) Islamabad Capital Territory
    10) Karachi
    11) Taluka of Hyderabad
    12) Taluka of Kotri
    13) Taluka of Sukkur
    14) Such areas adjoining Karachi and Lahore as may be specifed by the Central Board of Revenue.

(5) Machinery and raw material for manufacture of goods meant primarily and exclusively for export can be imported free of custom duty under bonded ware-house scheme.

(6) Import of following machinery and raw material are allowed free of custom duty against a bank guarantee subject to the condition that goods are exported within six months:

(a) Material for processing, further manufacturing or repair.
(b) Material for embellishing or decorating goods produced in Pakistan for export.
(c) Packing material used or required to be used as external or internal covering of goods, or as holders on which goods are rolled, wound or attached provided that they do not change their original shape or form (packing material such as straw, paper, glass and like materials excluded).
(d) Machinery and equipment for repair.
(e) Professional equipment imported by visiting technicians, doctors, etc.
(f) Equipment and material imported by visiting television and broadcasting units, press photographers and film companies.
(g) Scientific and educational instruments, apparatus and appliances including simultaneous broadcasting equipment imported for scientific, educational or cultural seminars to be held in Pakistan.
(h) Goods imported by Government or semi-Government institutions for demonstration purposes in their display centres.
(i) Goods imported for display at international or single country exhibition for foreign Missions.
(j) Machinery imported by the representatives of foreign commercial firms for demonstration purposes.

B. Tax holiday:

Complete tax holiday is available as per details given below:
(i) Tax holiday for five years from the date of commencement of commercial production to industrial undertakings set up by the Companies between July, 1978 to June, 1983, in the Province of Baluchistan.
(ii) Tax holiday for five years from the date of commencement of commercial production to industrial undertakings set up by the Companies between April, 1978 to June 1983, in the Divisions of D.I. Khan and Malakand in the N.W.F.P.
(iii) Tax holiday for five years from the date of commencement of commercial production to industrial undertakings set up by the Companies between July, 1979 to June, 1983, in Azad Kashmir, Northern Areas, Tribal Areas and districts of Mansehra and Kohistan of N.W.F.P.
(iv) Tax holiday for five years from the date of commencement of commercial production to industries set up in the District of D.G. Khan in the Province of the Punjab and in the approved industrial Estates in the whole of N.W.F.P., District of Mianwali and Tehsil Khushab in the Province of Punjab, and Districts of Shikarpur, Jacobabad and Dadu in the Province of Sind.
(v) Tax holiday for five years from the date of commencement of commercial production to industrial undertakings set up by the Companies between May, 1978 to June, 1983, anywhere in Pakistan for the manufacturing of garments from cloth made in Pakistan.
(vi) Tax holiday for five years from the date of commencement of commercial production to industrial undertakings set up by a company between May, 1978 to June, 1983 in the district of Sukkur in the Sind Province and engaged in the processing of dates, manufacture of chipboard or refining of edible oils.
(vii) Income from poultry farming and dairy farming, fish catching and cattle and sheep breeding is exempt from income tax for the period July, 1975 to June, 1983. A similar exemption is available to fish farming for the period July, 1977 to June, 1982 where such business is established after 1.7.1977.
(viii) Income from poultry processing derived from 1st July, 1980 to 30th June, 1983 is exempt from income tax.
(ix) Income from manufactures of agricultural implements is exempt from income tax till 30th June, 1983.

C. Tax credit for modernization, balancing, replacement and extension of machinery to company in respect of existing units:

Tax credit equal to 15% of the cost of machinery installed for modernization, balancing, replacement, and extension of existing of existing industrial units, is allowed to a company where such machinery is installed between July, 1976 and June, 1983.

D. Income of industrial companies which is partially exempt:

Profits of industrial companies set up between 1975 and 1983 are exempt to the extent of 10% of the capital employed in the undertakings set up in the areas excluding Talukas of Karachi and Hyderabad, Tehsils of Faisalabad and Lahore for a minimum period of 5 years from the year of commoncement of commercial production.

* Government of Pakistan, Finance Division (Investment & Capital Issues Wing).

E. Tax credit for investment by companies in industrial undertakings:

Tax credit is admissible to a company in respect of the amount invested in the acquisition of share-capital of a company which set up an industrial undertaking to the extent indicated below:

(a) 30% of the amount invested if the industrial undertaking is located in Baluchistan, Tribal areas, Northern Areas or Azad kashmir.

(b) 15% of the amount invested where industrial undertaking is located at any other place, excluding the Talukas of Karachi and Hyderabad and Tehsils of Faisalabad and Lahore.

F. Setting off losses of wholly owned subsidiary companies:

Listed holding companies have been allowed to set off current losses of a wholly owned subsidiary company against current year's income. The concession is available for three assessment years, and is subject to the condition that the holding company gives a scheme of revival of the sick mill duly approved by a financial institution namely PICIC, IDBP, NDFC or Bankers Equity and submits a yeraly progress report to the said financial institution, showing that progress is in accordance with the scheme of rehabiliation.

G. Tax exemption on capital gains:

Capital gains including gains arising on sales of shares for the assessment year upto 30-6-1984 have been exempted.

H. Tax holiday for non-residents:

No tax is charged on income, profits or gains which accrue or arise outside Pakistan to a person:

(i) Who has not been resident in Pakistan in nine out of ten years preceding the income year; or if

(ii) He has not during the seven years preceding that year been in Pakistan for a period of for periods aggregating to, more than two years.

This tax exemption is however, not available in case such income gains and profits are derived from a business controlled in a profession or vocation set up in Pakistan or are brought into or received in Pakistan during the income year.

I. Tax rebate on repatriation of income from consultancy services rendered abroad:

Non company resident professionals earning income from consultancy services abroad shall on repatriation of such income be entitled to a rebate equal to 30% of the tax payable on such income.

J. Investment allowances to persons other than companies:

An allowance of 33⅓% of the total income subject to a maximum of Rs. 40,000/– is admissible to any person, except a company, in NIT Units, specified certificates and debentures, in the acquisition and debentures, in the acquisition of the share-capital of industrial companies other than purchase from a previuos owner.

K. Exemption of dividend from income tax:

Following income from dividends is exempt from tax:

(a) From the National Investment (UNIT) Trust or any mutual fund established by the Investment Corporation of Pakistan or from a company listed on stock exchange in Pakistan, other than that specified in sub-clauses (b) or (c):

(i) Where such dividend income does not exceed fifteen thousand rupees.	(The whole of such income)
(ii) Where such dividend income exceeds fifteen thousand rupees.	(Fifteen thousand rupees)

(b) dividends declared and paid by (The whole of such income) any public company registered at any time between the first day of July, 1977 and the thirtieth day of June, 1982 (both dates inclusive) under the Companies Act, 1913 (VII of 1913), and having its registered office in Pakistan, out of its profits for any income year ending in or before the thirtieth day of June, 1982.

(c) dividend income received from any (The whole of such income) public company registered under the Companies Act, 1913 (VII of 1913), at any time between the first day of July, 1978 and the thirtieth day of June, 1982 (hereinafter referred to as the said period), having its registered office in Pakistan and engaged in an industrial undertaking set up in Pakistan at any time within the aforesaid period out of the profits of the undertaking, for a period of five years beginning from the year in which commercial production is commenced.

(d) There is no deduction of 30% standard rate of Income tax on dividends paid to overseas Pakistanis Certificate holders of State Enterprises Mutual Fund of ICP. In other words the income to the certificate holders residing abroad is tax free.

L. Bonus shares:

Face value of any bonus shares or the amount of any bonus declared, issued or paid by a company to its shares holders is exempt in the hands of shareholders.

M. Exemption to foreign technicians:

Salary received by any person who is not a citizen of Pakistan is exempt for a period of three years from the date of his arrival in Pakistan for services rendered by him during such period as a technician under a contract of service approved by the Commissioner of Income Tax before the commencement of his service or within one year of such commencement.

N. Tax rebate on income from exports:

Rebate is allowed to all commercial and industrial exporters at the rate of 55% of the tax attributable to income from export of goods manufactured in Pakistan.

O. Tax relief to cooperative societies:

Cooperative Societies are allowed earned income relief, personal allowance and investment allowance as admissible to individuals.

P. Super tax rebate:

Super tax rebate of 5% is allowed to industrial undertakings set up between July, 1975 and June, 1983 provided the cost of fixed assets exclusive of cost of land does not exceed Rs. 5.0 million.

In the case of domestic Public Companies, rates of super tax have been reduced on intercorporate dividends from 15% to 10%. In respect of Private Limited Companies the rate of super tax on intercorporate dividends received by such Companies has been reduced to 30%.

A Pakistani construction company earning income from constuction contracts abroad, shall on repatriation of profits to Pakistan be entitled to a rebate equal to the amount of super tax payable on such income.

Q. Tax credit on investment by companies in shares and debentures:

Companies investing in shares or debentures of the Equity Participation Fund are allowed tax credit of 50% of the amount invested in such shares or debentures.

R. Interest on approved loans exemption from income tax:

Interest payable on loans made by approved foreign institutions or on approved loans taken by industrial undertakings in Pakistan for purchase of plant and machinery complete exemption from Pakistan tax if the country from which the loan has emanated grants exemption from its own tax to the income in question or agrees to give credit in the home assessment of lender for tax payable on his income in Pakistan but exempted by Government.

S. Sales tax exemption on machinery:

Machinery and components thereof for industrial use are exempt from payment of sales tax both at the import stage as well as when locally manufactured.

T. sales tax exemption on export of manufactured goods:

In order to promote the export of manufactured goods, a general exemption from sales tax is given to all goods exported from Pakistan. In addition, the raw material used in their manufacture is also exempted from sales tax.

U. Depreciation allowance:

Depreciation allowance is calculated on the cost of assets at the time of their acquisition in the first year and on the written down value in subsequent years.

An initial depreciation allowance at the rate of 30% is allowed on ships and at a rate of 25% on other plant and machinery installed between July, 1976 and June, 1983. Rate of depreciation allowance on residential buildings for industrial labour is 10%. Buildings constructed upto 30th June, 1983 for industrial labour drawing salary upto Rs. 1000 per month are allowed an initial depreciation at the rate of 25%.

In respect of assets most commonly in use of rates of normal depreciation allowance are as follows:

(1) Building (not other-wise specified)	5%
(2) Factory or workshop (excluding godowns, Offices and residential quarters)	10%
(3) Furniture	10%
(4)/ Machinery and plant (not other-wise specified)	10%
(5) Ships	
(i) New	5%
(ii) Second Hand Age at the time of purchase:	
(a) not more than ten years	10%
(b) more than ten years	20%
(6) Batteries, X-Rays and electro-therapeutic apparatus and accessories	20%
(7) Machinery used in the production and exhibition of cinematograph films	20%
(8) Motor-vehicles, all sorts	20%
(9) Aircraft, aeroengines and aerial photographic apparatus	30%
(10) Moulds used in the manufacture of Glass or concrete pipes	30%
(11) Below ground installations in mineral oil concerns	100%

Extra depreciation allowance is also allowed for multiple shift working. In the case of machinery and plant, to which the general rate applies an extra depreciation allowance, equal to 50% of the allowance computed is allowed on account of double shift working and 100% of such allowance on account of triple shift working.

Limit for claiming depreciation allowance of original cost of motor vehicles has been increased from Rs. 75,000 to 100,000 for assessment year 1982-83.

V. Housing:

Tax relief has been provided to Pakistanis working abroad who maintain a house in Pakistan for their families. The mere maintenance of a house will no longer render a tax payer liable on foreign income. Further the condition regarding short visits to Pakistan has been relaxed and any tax payer, whose stay in Pakistan does not extend beyond 90 days, will not incur any extra tax liability.

W. Tariff protection:

Exemption from tax has been granted to new residential houses constructed between 1st July, 1981 and 30th June, 1983, and having annual rental value upto Rs. 18,000. For Islamabad, the exemption for new houses is Rs. 24,000/–.

X. Financing facilities:

(i) Lending rate for financing of fixed industrial investment has been reduced from 14% to 11%.
(ii) On rupee loans for purchase of locally fabricated machinery, IDBP charges incterest at the rate of 8½%. PICIC/NDFC also provide loan for purchase of locally fabricated machinery at concessionary rates.
(iii) Bakers Equity Limited have been established to make up rupee equity gap being faced by private investors.

Y. Tax concessions for the mineral industry:

(i) Depreciation is allowed @ 100% on below ground installations in mineral oil concerns.
(ii) Capital loss incurred upto the time of commercial production is treated as a revenue loss and allowed to be carried forward for a period of 10 years after the commercial production.
(iii) Depletion allowance is admissible @ 15% of the gross receipts in respect of exploration and production of petroleum and 15% of total income from extraction of other mineral deposits or 50% of the capital employed, whichever is the less.
(iv) Depreciation allowance @ 100% is allowed in respect of machinery and plant acquired for extracting mineral (other than petroleum) in the year in which they are used for the first time.
(v) Tax exemption upto 10% of the capital employed is available to an undertaking which is also engaged in the business of refining or concentrating in Pakistan the mineral deposits extracted by it in Pakistan. This concession is for mineral other than petroleum only.
(vi) Pakistani companies engaged in the exploration of selected minerals mentioned below have been given exemption for 5 years; and on the expiry of the 5 years, tax on such income shall be charged at 50% of the normal rate for next 5 years.

(i) Iron Ore; (ii) Byarite; (iii) Dolomite; (iv) Fireclay; (v) Lime Stone; (vi) Flourite; (vii) Bauxite; (viii) Phosphate; (ix) Chrome; (x) Soap stone and (xi) Copper.

Z. Export processing zone:

An export processing zone has been established at Karachi. Another one is contemplated near Lahore. These zones aim at enabling establishment of export-oriented industries. Exports from the Zones will be completely free from exchange control. Import of machinery, components, spare parts and raw matrerials for the industrial undertakings in the Zones and goods for re-export would be freely allowed and shall be exempt from all taxes and duties of both Federal and Provincial Governments including municipal taxes. The restrictions of Import Trade Control Act would not be applicable on imports into the Zones. Investors in the zones would be allowed following income tax relief:

(a) Income of the enterprise and of the foreign employees will be exempt from tax for five years which period is extendable by the Federal Government in the light of the performance of the enterprise.
(b) After the expiry of full tax-holiday period, a concessional rate of tax at ¼th of the prevalent tax rates shall be charged for next 5 years.
(c) Capital gains on sale of assets and shares will be exempt from tax.

Financial institutions

Providing credit and equity for industrial projects in Pakistan.

1. Investment Corporation of Pakistan, National Bank Building, I.I. Chundrigar Road, Karachi.
2. Industrial Development Bank of Pakistan, State Life Building, I.I. Chundrigar Road, Karachi.
3. Pakistan Industrial Credit & Investment Corporation, State Life Building, I.I. Chundrigar Road, Karachi.
4. National Investment Trust, National Bank Building, I.I. Chundrigar Road, Karachi.

5. National Development Finance Corporation, NSC Building, Maulvi Tamizuddin Khan Road, Karachi.
6. Bankers Equity Limited, State Life Building, Dr. Zia-ud-Din Ahmad Road, Karachi.
7. Small Business Finance Corporation, National Bank Building, Civic Centre, Islamabad.
8. Equity Participation Fund, State Life Building, I.I. Chundrigar Road, Karachi.
9. Pak-Kuwait Investment Company Limited, Shaikh Sultan Trust Building, Beaumont Road, Karachi.
10. Pak-Libya Holding Company Limited, Shaikh Sultan Trust Building, Beaumont Road, Karachi.
11. Saudi-Pak Industrial, Agricultural Investment Company Ltd., P.O. Box No. 1594, Islamabad.

CUMULATIVE INDEX 1982 - Nos. 1 – 6

I. ARTICLES

[Continued on page 325]

INDIA:

IMPACT OF THE BUDGET*

No incentives to produce or save

By Kailash C. Khanna

In an address to the Income Tax Payers' Society in England, Sir Paul Chambers, who was responsible for an overhaul of the Indian income-tax law in 1939, once stated:

> It is easy to press for the separation of the taxation of individuals from the taxation of companies; once you have done that, the Chancellor, whatever his Party, will always be pressed to give more relief to individuals and classes of individuals because they are the people who vote and the taxation on industry will go up and up. And there again, politically companies are less articulate than individuals and classes of individuals. It is so easy to slip into doing the wrong thing.

The truth of this statement is amply borne out by India's corporate tax development. It was in 1959 that taxation of company profits was separated from taxation of shareholders. The rate of corporate tax was then fixed at 45%; it has since gone "up and up" and now stands at 55% for a widely held domestic company, exclusive of surcharge on tax (2.5%) and surtax (25% to 40%) on net profits in excess of 15% of capital and reserves. The aggregate tax burden can reach an unheard of maximum of 70%. The rates for closely held companies are still higher.

It was, therefore, expected that in his 1982-83 Budget proposals the Union Finance Minister, Mr. Pranab Mukherjee, would reduce company tax rates and modify the corporate tax structure. Belying these expectations, the Finance Bill does not suggest any noteworthy changes in the existing rates or basis of corporate taxation. Apparently, relying on scanty data and by citing stray cases of a few newly established or recently expanded companies which have derived full benefit of the initial tax reliefs and incentives, the Finance Minister's advisers came to the mistaken belief that corporate tax in India is not high. But it is fallacious to justify a high corporate tax rate on the grounds that numerous tax reliefs are available in the formative years. A company does not establish itself anew every now and then, nor does it acquire substantial new plant and machinery year after year. Consequently, the tax liability goes up when the initial allowances are exhausted or are nullified by disallowance of bona fide business expenditure. A low tax burden in the early years followed by confiscatory taxation in later years seems to justify the adage that tax incentives are short-term bribes for long-term handicaps. In any event, companies which have availed themselves of tax concessions are contributing to the development process and adding to the GNP. In fact, this is exactly what tax benefits are meant for and it should be a matter for gratification that the fiscal bait has worked.

A realistic basis for determining the average tax rate would be to ascertain the percentage of the tax levied on corporate profits during a financial year; this is likely to show a figure close to the standard rate. A study conducted by the Associated Chambers of Commerce & Industry of India showed that a 1% increase in corporate tax reduced resources of the company by 1.3%. Another study has shown that while corporate taxation has increased many times over the years, corporate savings have declined sharply. Apart from discouraging the generation of internal resources, high corporate taxation hampers corporate growth, distorts the debt-equity ratio, encourages corporate extravagance, erodes integrity and shifts the corporate tax burden, thereby mulcting the consumer and fanning the flames of inflation. It is, therefore, imperative to lower company tax rates, increase depreciation allowances, remove tax on all intercorporate dividends and abolish surtax on company profits.

In the Finance Bill, the existing tax exemption limit of income from dividends, bank interest etc. is proposed to be raised from Rs. 3,000 to Rs. 4,000; that from Unit Trust from Rs. 2,000 to Rs. 3,000. Corresponding changes are proposed in the wealth tax law increasing the exemption limits to Rs. 165,000 and Rs. 35,000 respectively. It is proposed to increase the maximum amount of investment qualifying for the prescribed deduction relating to equity shares of an eligible issue of capital of new industrial companies or public housing finance companies from Rs. 10,000 to Rs. 20,000. The proposed changes are too trivial to have any effective impact on investment and savings.

The proposed tax relief to exporters, whose export turnover during the accounting year exceeds the export turnover of the immediately preceding year by more than 10% thereof is not available to all. The goods in relation to which the tax concession will be provided and the rate at which the relief will be calculated will be notified by the Central Government after taking into account the cost of manufacture of such goods, the prices of similar goods in the foreign market, the need to develop a foreign market for such goods, the need to earn foreign exchange, the destination of export and any other relevant factors. The maximum amount of deduction to which the taxpayer will be entitled will not exceed 10% of the amount of income tax otherwise payable by the taxpayer on the profits and gains from export of such goods. These limitations will detract considerably from the expected boost to exports. The tax benefit will be available for the 1983/84 assessment and 4 immediately succeeding assessment years.

With a view to encouraging contractors to undertake construction and engineering contracts outside India, it is proposed to provide that where an Indian company or a non-corporate taxpayer resident in India derives any profits and gains from the business of execution of a project under a contract entered into by him with the Government of a foreign State or any statutory or other public authority or agency in a foreign State or with a foreign enterprise, he will be entitled to a deduction, in the computation of his taxable income, of 25% of such profits

* This is a revised version of an article which appeared in *The Statesman* of 16 March 1982. The Editors of *The Statesman* kindly approved re-publication of Mr. Khanna's article.

and gains, subject to certain conditions. This concession will also be available where the taxpayer undertakes the execution of any work in connection with any foreign project undertaken by any other person.

The benefit of this concession will be available in respect of projects for the construction of any building, road, dam, bridge or other structure outside India, the assembly or installation of any machinery or plant outside India, and the execution of such other work outside India of whatever nature as may be prescribed by the Central Board of Direct Taxes. The taxpayer will not be eligible for this concession unless the consideration for the execution of such project or work is payable in foreign currency and the following conditions are fulfilled:

(a) The taxpayer will have to maintain separate accounts in respect of the profits and gains derived from the business of the execution of the project or work forming part of the project.

(b) The taxpayer will be required to debit to the profit and loss account of the relevant accounting year and credit to a "Foreign Projects Reserve Account" a sum equal to 25% of the profits and gains from such project or work. The reserve must be utilised by the taxpayer during a period of 5 immediately succeeding assessment years for the purpose of his business and not for distribution by way of dividend or profits.

(c) The taxpayer will be required to remit into India in foreign exchange an amount equal to 25% of such profits and gains within a period of 6 months from the end of the relevant accounting year.

Where, however, the amount credited by the taxpayer to the Foreign Projects Reserve Account or the amount actually remitted into India by him or either of these amounts is less than 25% of such profits and gains, the deduction will be restricted to the amount so credited to the Foreign Reserve Amount, or the amount actually brought by him to India, whichever is less.

This is a useful suggestion and will be of value to specified overseas projects which make profits.

It is proposed to extend up to 31 March 1987 the grant of investment allowance now admissible at the higher rate of 35% to specified plant and machinery. Another suggestion seeks to exempt from tax intercorporate dividends in the case of 3 more industries, namely, synthetic rubber, chemicals and basic drugs.

In the field of personal taxation an increase in the standard deduction from 20% to 25% of salary, subject to a maximum of Rs. 5,000, is proposed; this will benefit salaried taxpayers only. Surely, salaried employees alone do not constitute the entire middle class; there is a very large number of self-employed small traders, retailers, artisans, builders, craftsmen and professionals who also form part of the same income group. Unlike salaried employees, the self-employed are not entitled to reimbursement of medical and leave travel expenses, gratuities and other like benefits. The apparent bias against the self-employed compels even the honest amongst them to seek redress in tax evasion and avoidance. Suitable amendments to remove these inequities are urgently called for in the interest of taxpayer morality.

A welcome feature of the Finance Bill is the promised modification of the provisions relating to the exemption from capital gains on transfer of house property. The condition of self-occupation of the property by the taxpayer will be deleted and the period for construction of a new property will be increased from 2 to 3 years. Likewise, capital gains arising from the transfer of certain long-term capital assets will be entitled to tax exemption provided the net consideration is utilised by the taxpayer for the purchase or construction of a house property within the specified period. But why restrict the utilisation to house property only? Mr. Pranab Mukherjee should go the whole hog and exempt all capital gains from tax if the net consideration is reinvested within the stipulated period in approved productive assets, movable or immovable. It is also proposed to relate the deduction in respect of long-term capital gains to the period for which the capital asset has been held; higher deduction being allowed if the capital asset is held for a longer period.

Under the existing provisions, an individual is said to be "resident" in India in any year, if:

(a) he is in India in that year for a period or periods amounting in all to 182 days or more; or

(b) he maintains or causes to be maintained for him a dwelling place in India for a period or periods amounting in all to 182 days or more in that year and has been in India for 30 days or more in that year; or

(c) having within the 4 years preceding that year been in India for a period or periods amounting in all to 365 days or more, is in India for a period or periods amounting in all to 60 days in that year.

In the case of an Indian citizen who is rendering service outside India, and who is on leave or vacation in India, the periods of 30 days and 60 days referred to in (b) and (c) are taken as 90 days.

With a view to avoiding hardship in the case of Indian citizens who are employed or engaged in other avocations outside India, the Finance Bill seeks to make the following modifications in the tests of "residence" in India:

(a) it is proposed to omit the provision relating to maintenance of a dwelling place coupled with stay in India of 30 days or more;

(b) in the case of Indian citizens who come on a visit to India, the period of "60 days or more" is proposed to be raised to "90 days or more";

(c) it is proposed to provide that where an individual who is a citizen of India leaves India in any year for purposes of employment outside India, he will not be treated as resident in India in that year unless he has been in India in that year for 182 days or more. The effect of this amendment will be that the "test" of residence in (c) above will stand modified to this extent.

With a view to encouraging the remittance of foreign exchange into the country by non-resident Indian citizens and foreign nationals of Indian origin, it is proposed to exempt from gift tax, gifts of foreign currency or other foreign exchange made by such persons to their relatives in India. For this purpose, "relative" in relation to an individual will mean the husband, wife, brother or sister or any lineal ascendant or descendant of that individual.

Gifts made by such persons out of the moneys to their credit in a Non-resident (External) Account in India will also qualify for exemption.

But tinkering with the tax rate schedule applicable to individuals with incomes between Rs. 60,000 and Rs. 100,000 is contrary to Mr. Mukherjee's declared objective of maintaining the stability of law. The increased annual tax burden on individuals with incomes of Rs. 100,000 and above will be a maximum of Rs. 688 only; the gain to the Exchequer will be negligible but the psychological damage to the taxpayer will be tremendous. Individual initiative and enterprise will be stifled and the Government will loss its credibility. The rationale behind the proposed change is not at all clear suggesting little more than a political gimmick; this illogical proposal should be dropped.

The suggested increase in tax relief in regard to long-term savings such as life insurance premia and provident fund contributions is again marginal and not of much consequence; few taxpayers, if any, will be able to avail themselves of the proposed increase in the monetary ceiling of Rs. 40,000.

The Budget speech highlighted the buoyancy in revenue, decline in inflation and an alleged environment of strong agricultural and industrial growth in 1981-82. But Mr. Pranab Mukherjee did not rise to the occasion; on the contrary, he failed to provide adequate incentives for increasing production and savings. His direct tax proposals are too feeble and halting to assist in the achievement of the aims and objects outlined by him.

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[Continued from page 322]

II. REPORTS AND DOCUMENTS

UNITED STATES:

Competent Authority Consideration

Allocation of income or deductions*

SEC. 1. PURPOSE AND SCOPE

This revenue procedure explains the procedures to be used by the Internal Revenue Service and taxpayers in certain cases of double taxation that are governed by income tax treaties of the United States. The cases covered by this revenue procedure concern the allocation of income and deductions between a United States taxpayer and a related person (including a branch office) subject to the taxing jurisdiction of a country ("treaty country") that has entered into an income tax treaty with the United States. See Rev. Proc. 77-16, 1977-1 C.B. 573, for competent authority procedures used in resolving issues other than allocation of income and deductions, including the availability to United States taxpayers of credits against foreign tax, exemptions from foreign tax, reduced rates of foreign tax, and other benefits and safeguards. Rev. Proc. 70-18, 1970-2 C.B. 493, as amplified by Rev. Proc. 79-31, 1979-1 C.B. 599, is modified and superseded by this revenue procedure.

SEC. 2. BACKGROUND

01. Income tax treaties in force between the United States and other countries generally provide for the allocation of income and deductions among related persons whose dealings with each other are not the same as those that would be made between independent persons. These treaties recognize that taxation by a treaty country of a taxpayer with an affiliate or branch office that is subject to the taxing jurisdiction of the other treaty country may result in actual or economic double taxation. As a result, these treaties provide for consultation by the competent authorities of the United States and of treaty countries on the allocation of income and deductions between related persons. The provisions of this revenue procedure do not override the provisions of any income tax treaty entered into by the United States. Taxpayers should make themselves aware of the full content of the income tax treaty under which they are operating.

02. When the United States competent authority and a treaty country competent authority agree to discuss an allocation, whether made or proposed by the United States or by the treaty country, the United States competent authority will attempt to reach an agreement that is acceptable to the United States, to the treaty country, and to the related persons.

03. The Associate Commissioner (Operations) acts as the United States competent authority in administering the operating provisions of tax treaties and in interpreting or applying these treaties. In interpreting or applying tax treaties, the Associate Commissioner (Operations) acts only with the concurrence of the Associate Chief Counsel (Technical).

04. If the United States taxpayer fails to request competent authority consideration under this revenue procedure, the taxpayer may be denied a credit for foreign tax. See Rev. Rul. 76-508, 1976-2 C.B. 225, as amplified by Rev. Rul. 80-231, 1980-2 C.B. 219, and section 4.901-2(f)(5) of the Temporary Income Tax Regulations, T.D. 7739, 1981-1 C.B. 396.

05. The Associate Commissioner (Operations) may negotiate an agreement with the competent authority of a treaty country concerning the allocation of income or deductions between a United States taxpayer and a related person at the request of the United States taxpayer. The Associate Commissioner (Operations) also may initiate competent authority negotiations in any situation to protect United States economic interests. Such a situation may arise when a taxpayer fails to request competent authority consideration after agreeing to an allocation of income or deductions that creates either actual or economic double taxation.

06. The taxpayer should send written requests for competent authority consideration to the Associate Commissioner (Operations), Internal Revenue Service, P.O. Box 7799, Washington, D.C. 20044.

SEC. 3. GENERAL CONDITIONS UNDER WHICH THIS PROCEDURE APPLIES

01. The procedure prescribed in sections 3 through 9 of this revenue procedure apply when the United States or other treaty country allocates or proposes to allocate income or deductions and this allocation may result in actual or economic double taxation.

02. In seeking to arrive at an agreement with a treaty country, the United States competent authority will be guided by the standards of arm's length dealing (referred to in the regulations under section 482 of the Internal Revenue Code) and the equivalent standard of arrangements or conditions that would have been made between independent persons (referred to in a number of treaties). The United States competent authority also will take into account all of the facts and circumstances and the purpose of the treaty to avoid double taxation when negotiating agreements on the allocation of income and deductions.

03. It is the position of the United States competent authority not to re-open a case previously closed after examination to make an adjustment unfavorable to the taxpayer unless the exceptional circumstances described in Rev. Proc. 74-5, 1974-1 C.B. 416, are present. The United States competent authority may accept a taxpayer's request for competent authority consideration that will require the reopening of a case closed after examination.

04. If there is no income tax treaty between the United States and another country there is no authority for the Service to provide relief from United States tax due to double taxation arising under the tax laws of the other country and the United States. Therefore, in such a case the United States competent authority is unable to consider a taxpayer's request that involves a nontreaty country.

SEC. 4. PROCEDURES TO BE FOLLOWED IF TREATY COUNTRY PROPOSES ALLOCATION

01. If a treaty country allocates or proposes to allocate the income or deductions attributable to transactions involving a United States taxpayer, the United States taxpayer should request United States competent authority consideration.

02. The taxpayer must file a written request for competent authority consideration with the Associate Commissioner (Operations). Internal Revenue Service, P.O. Box 7799, Washington, DC 20044, as soon as practical after the treaty country's position on the adjustment has been sufficiently developed to permit consideration, whether or not the adjustment has been formally proposed. In any event, the request should be filed no later than 90 days after the treaty country's adjustments are formally communicated to the related person.

03. At the time of the request for competent authority consideration, the United States taxpayer must file an amended United States tax return (for exeample, a Form 1120X Amended U.S. Corporation Income Tax Return if a Form 1120 was originally filed), as provided by the regulations under section 6402, with the Internal Revenue Service Center where the original return for the same tax year was filed. On the amended United States tax return the taxpayer may claim a credit or refund of the taxes attributable to the proposed allocation and shall indicate that a competent authority request is being filed. A copy of the amended United States tax return shall be attached to the request for competent authority consideration.

* Rev. Proc. 82-29.

04. The competent authority request must be signed by a person having authority to sign the United States taxpayer's federal income tax returns. The request must contain a statement that competent authority consideration is being requested and must include the following information:

(a) a reference to the specific income tax treaty provisions under which the request is made;
(b) the names, addresses, and taxpayer identification numbers of the United States taxpayer and all related persons involved in the proposed allocation and the tax years affected;
(c) the office where the United States taxpayer and the related person or persons filed federal income tax returns for the years in question;
(d) a statement whether the federal income tax returns of both the United States taxpayer and the related person or persons for the years in question were examined, or are in the process of being examined;
(e) a description of the control and business relationships between the United States taxpayer and the related person or persons;
(f) a statement of the status of the tax liability of the related person in the treaty country for the year or years of the proposed adjustment;
(g) actions requested of, proposed, or taken by the competent authority of the treaty country, a description of the pertinent transactions and the issues, and the amount of any correlative adjustment that would have to be made to the income or deductions of the United States taxpayer if the United States competent authority were to accept the position of the treaty country;
(h) copies of pertinent foreign income tax returns (with English translation), and a schedule (in United States dollars) showing the allocation proposed by the treaty country and computation of the resulting foreign tax;
(i) copies of pertinent correspondence from the treaty country, briefs, protests, and other relevant material (with English translation);
(j) copies of Foreign Tax Credit Computation (Forms 1118) that were filed with the tax return for each year under consideration;
(k) copies of powers of attorney on file with respect to the United States taxpayer; and
(l) on a separate document, a statement that the United States taxpayer consents to the disclosure to the competent authority of the treaty country (with the name of the country specifically stated) and the competent authority's staff of any or all of the items of information set forth or enclosed in the request for United States competent authority consideration. This statement must be dated and signed by a person having authority to sign the United States taxpayer's federal income tax return and is required to facilitate the administrative handling of the request by the United States competent authority for purposes of the recordkeeping requirements of section 6103(p) of the Code. Failure to provide such a statement will not prevent the United States competent authority from disclosing information under the terms of a tax treaty. See section 6103(k)(4).

05. If a treaty country is considering but has not yet proposed any adjustments to income or deductions arising out of transactions of or with a United States taxpayer, and the United States statutory period in which the United States taxpayer can file a claim for credit or refund of income taxes for the years involved is about to expire, the United States taxpayer should file a protective claim for credit or refund of these taxes on the appropriate amended United States tax return (including, to the extent available, the information required in a competent authority request under section 4.04 above). The amended United States tax returns must be filed with the Internal Revenue Service Center where the original tax return for the same tax year was filed. The taxpayer must send a copy of the amended United States tax return to the Associate Commissioner (Operations) (see section 2.06 above for address). Final disposition of the amended United States tax return will be deferred by the Service pending: (1) the perfection of the request for competent authority consideration under section 4.01 above and the disposition of the issues under consideration; or (2) the withdrawal of the claim for credit or refund by the taxpayer. Beginning 6 months after the amended United States tax return is filed and every 6 months thereafter, the taxpayer must state in writing (by a person authorized to sign its federal income tax returns) to the Associate Commissioner (Operations) that the treaty country is still considering an adjustment of the income or deductions. The statement must include any available information described in section 4.04 above not previously submitted and any necessary modifications or previously submitted information. The Associate Commissioner (Operations) may deny competent authority consideration if the United States taxpayer fails to file the supplemental statement within each 6 month period.

06. The amended United States tax return filed under this revenue procedure permits only the making of a credit or refund that is agreed to by the United States and the treaty country competent authorities or that is unilaterally allowed by the United States competent authority. This revenue procedure does not grant a United States taxpayer the right to invoke section 482 of the Code in its favor or compel the Service to allocate income or deductions or grant a tax credit or refund. If the United States taxpayer accepts the decision of the competent authority, the decision of the competent authority is not subject to judicial review.

SEC. 5. PROCEDURES TO BE FOLLOWED IF THE UNITED STATES PROPOSES ALLOCATION

01. If the Service allocates or proposes to allocate income or deductions attributable to transactions involving a United States taxpayer subject to the tax jurisdiction of a treaty country, the United States taxpayer should request United States competent authority consideration. (See Rev. Rul. 76-508, as amplified by Rev. Rul. 80-231. Also see section 6 of this revenue procedure for procedures to be followed by the related person if any.)

02. A written request for competent authority consideration should be submitted as soon as the amount of the adjustment is determined, communicated in writing to the taxpayer, and agreed to by the taxpayer subject to competent authority relief. Taxpayers who do not agree with the correctness of the adjustment are encouraged to pursue their right of administrative review befor the Appeals Division before requesting competent authority relief.

0.3 The taxpayer must file the written request for competent authority consideration with the Service office where the United States taxpayer's case is pending. A copy of the request must be filed with the Associate Commissioner (Operations), Internal Revenue Service, P.O. Box 7799, Washington, DC 20044. However, if the request for competent authority is not filed until after a suit contesting the tax liability of the taxpayer is pending in a court in the United States, the request should be filed with the Chief Counsel, Attention: Associate Chief Counsel (Litigation), Internal Revenue Service, Washington, DC 20044, and a copy filed with the Associate Commissioner (Operations).

04. The Internal Revenue Service office receiving the written request for competent authority consideration will promptly forward a copy of the request, pertinent files, and other appropriate information and documents to the Associate Commissioner (Operations).

05. If a request for competent authority consideration is filed, the Service will postpone further examination action on the issues accepted for competent authority consideration, except for cases pending in court and other cases in which action must be taken to avoid prejudicing the Government's interest. If there are other issues raised during the examination and the taxpayer is not in agreement with these issues, the district director will follow the usual procedures and issue the taxpayer a thirty-day letter. In preparing a protest of the unagreed issues, the taxpayer need not include any unagreed issue under consideration by the competent authority. Following the receipt of the taxpayer's protest, appeal procedures shall be initiated with respect to those issues not subject to competent authority consideration. If the competent authorities are unable to resolve the double taxation problem to the satisfaction of the United States taxpayer and the taxpayer wishes to then pursue other administrative or judicial avenues of appeal, the original protest will then be amended to include the issue unresolved by the competent authority.

06. The United States competent authority

will not accept any taxpayer's request for consideration of a case that is pending in court without Chief Counsel's consent. If the case is pending in the United States Tax Court, the Chief Counsel may in appropriate cases request the court to delay trial pending competent authority action. If the case is pending in any other court, the Chief Counsel will consult with the Department of Justice about appropriate action. Final decision on delaying trial rests with the court. However, the filing of a competent authority request does not relieve the taxpayer from taking any action that may become necessary with respect to litigation. On completion of the competent authority consideration, the taxpayer must reinstate litigation if the taxpayer decides to continue litigation.

07. The competent authority request must be signed by a person having authority to sign the United States taxpayer's federal tax returns. The request must contain a statement that competent authority consideration is being requested and must include the following information:
(a) a reference to the specific income tax treaty provisions under which the request is made;
(b) the names, addresses, and taxpayer identification numbers of the United States taxpayer and all related taxpayers involved in the proposed allocation and the tax year affected;
(c) the district office which has made or is proposing to make the adjustment;
(d) a description of the control and business relationships between the United States taxpayer and the related person or persons;
(e) a statement of the status of the tax liability of the related person in the treaty country for the year or years of the proposed adjustment;
(f) actions requested of, proposed, or taken by the competent authority of the treaty country, a description of the pertinent transactions and the issues and the amount of any correlative adjustment that would have to be made to the related person's income or deductions if the treaty country competent authority were to accept the position of the United States;
(g) the adjustments should be stated in United States dollars and the appropriate foreign currency, identifying the conversion method used to reconcile the United States entity's books and records with the foreign entity's books and records;
(h) copies of pertinent foreign income tax returns, correspondence, briefs, protests, and other relevant material (with English translation);
(i) copies of Foreign Tax Credit Computation (Forms 1118) that were filed with the tax return for each year under consideration;
(j) copies of powers of attorney on file with respect to the United States taxpayer;
(k) copies of pertinent Forms 2952 (Information Return with Respect to Controlled Foreign Corporations), including copies of the financial statements and surplus analysis required to be filed with the return for each related entity and for each year under consideration; and
(l) on a separate document, a statement that the United States taxpayer consents to the disclosure to the competent authority of the treaty country (with the name of the country specifically stated) and the competent authority's staff of any or all of the items of information set forth or enclosed in the request for competent authority consideration. This statement must be dated and signed by a person having authority to sign the United States taxpayer's federal income tax returns and is required to facilitate the administrative handling of the request by the United States competent authority for purposes of the recordkeeping requirements of section 6103(p) of the Code. Faillure to provide such a statement will not prevent the United States competent authority from disclosing information under the terms of a tax treaty. See section 6103(k)(4).

SEC. 6. NOTIFICATION TO RELATED ENTITY

In any case covered by section 4 or 5 of this revenue procedure, the United States taxpayer should either itself take, or advise a related person to take, such timely protective action as may be necessary with foreign tax authorities. This includes the staying of the expiration of the foreign period of limitations on the making of a refund or other tax adjustment, complying with any applicable procedures of the treaty country for invoking competent authority consideration, and attempting to resist an adjustment or obtain an appropriate correlative adjustment.

SEC. 7. CASES RECEIVED FROM AND REFERRED TO, FOREIGN COMPETENT AUTHORITIES

01. The United States competent authority will not initiate action under this revenue procedure with respect to foreign corporations, partnerships, or other entities of a treaty country. Requests sent to the United States competent authority by these taxpayers will be referred to the competent authority of the treaty country.

02. When a treaty country competent authority refers a request for mutual agreement to the United States competent authority, the United States competent authority will contact the United States taxpayer and advise the taxpayer to comply with this revenue procedure in order to obtain consideration by the United States competent authority.

SEC. 8. REV. PROC. 65-17

Rev. Proc. 65-17, 1965-1 C.B. 833, and Amendment I of Rev. Proc. 65-17, 1966-2 C.B. 1211, as amplified by Rev. Proc. 65-31, 1965-2 C.B. 1024, provide that the United States taxpayer must file a request for the treatment provided by Rev. Proc. 65-17 in writing with the appropriate district director before closing action is taken on the section 482 issue that forecloses availability of Rev. Proc. 65-17. Therefore, if a United States taxpayer desires competent authority action and the benefits provided by Rev. Proc. 65-17, the taxpayer must file a request under Rev. Proc. 65-17 before entering into any closing agreement or before any other closing action (as defined in section 4.03 of Rev. Proc. 65-31) is taken on the section 482 issue.

Rev. Rul. 82-80, page 7, this [Internal Revenue] Bulletin, states that a United States subsidiary, whose taxable income has been increased for a tax year because of an allocation under section 482 of the Code, may receive payment from its foreign parent corporation from which, or to which, the allocation of income or deductions was made, in an amount not in excess of the taxable income increase without further federal income tax consequences. For procedures to be followed in applying this position and requirements that must be fulfilled to qualify for such treatment, see Rev. Proc. 65-17.

SEC. 9. ACTION BY COMPETENT AUTHORITY

01. The United States taxpayer will be notified if the facts provide a basis for competent authority assistance. The United States competent authority will not assist the taxpayer if:
(a) under the facts and circumstances the taxpayer is not entitled to such assistance (for example, actual or economic double taxation does not exist);
(b) the taxpayer indicates unwillingness to accept a competent authority agreement except under conditions that are clearly unreasonable or unfairly prejudicial to the interests of the United States;
(c) the taxpayer does not accept the concept that competent authority negotiations are a government to government activity that does not include the taxpayer's participation in the negotiation proceedings;
(d) the taxpayer does not furnish, upon request, sufficient information to determine whether the treaty applies to the taxpayer's facts and circumstances, or the taxpayer otherwise fails to act as required by this procedure;
(e) the request is from a taxpayer under the jurisdiction of another competent authority (see section 7.01 of this revenue procedure); or
(f) the taxpayer has demonstrated an unwillingness to execute a consent extending the period of limitations on assessment of tax for the tax year or years under consideration (see section 9.02 of this revenue procedure).

02. If the United States competent authority accepts a request for consideration, the United States taxpayer must supply any additional information needed to resolve the case

and keep the United States competent authority informed about proceedings in the treaty country or any other pertinent developments. The taxpayer also may be requested to execute a consent extending the period of limitations on assessment of tax for the tax year or years concerned.

03. If the United States competent authority denies assistance, the United States taxpayer may ask the Commissioner of Internal Revenue to name a panel and have the panel review the denial of assistance. The panel will notify the taxpayer that the taxpayer may present oral arguments at a hearing, if so desired, in support of the taxpayer's request for competent authority assistance. The decision of the panel whether competent authority assistance should be provided is final and is not subject to judicial review. The United States competent authority will notify the taxpayer of the panel's decision. If the panel decides that the case is suitable for competent authority assistance, the United States competent authority will assist the taxpayer in accordance with this revenue procedure.

04. The United States competent authority will notify a taxpayer requesting assistance under this revenue procedure of any agreement or partial agreement that the United States and the treaty country competent authority reach with respect to the request. If such agreement or partial agreement is not acceptable to the taxpayer, the taxpayer may withdraw the request for competent authority consideration and may then pursue all rights to administrative and judicial review otherwise available under the laws of the treaty country and the United States.

05. When appropriate, in cases covered by sections 4 and 5 of this revenue procedure, the taxpayer will be requested to enter into a closing agreement reflecting the terms of the competent authority in accordance with sections 6.07 and 6.17 of Rev. Proc. 68-16, 1968-1 C.B. 770.

06. The United States competent authority will not grant unilateral relief to a United States taxpayer with respect to an adjustment to income, deductions, credits or other items solely because the period of limitations has expired in the foreign country and the competent authority of that country has declined to grant any relief from double taxation.

If the period provided by the foreign statute of limitations has expired, then the United States competent authority may take into account other relevant facts and may, as a matter of discretion, provide unilateral relief with respect to the adjustment to the extent necessary to avoid actual or economic double taxation of income. Relevant facts include the absence of actual or constructive notice of the proposed allocation so that the taxpayer could not avail itself of any remedies in the foreign jurisdiction; the absence of abusive tax arrangements in the structuring of the relevant international relationships and transactions; and the absence of recurring adjustments. In no event, however, will relief be granted where there is fraud or negligence with respect to the relevant international relationships and transactions.

Unilateral relief wil generally only be granted by the United States in the context of a tax treaty used by the other competent authority to grant unilateral relief to taxpayers of that country. If an income tax treaty is not in force with a particular foreign coutry, then the service wil not provide relief with respect to an adjustment because the period of limitations of that country has expired.

SEC. 10. REQUEST FOR RULINGS

01. Requests for advance rulings about the interpretation or application of a treaty on United States taxation, as distinguished from requests to the United States competent authority under this revenue procedure or Rev. Proc. 77-16, should be submitted to the Associate Chief Counsel (Technical) in accordance with Rev. Proc. 80-20, 1980-1 C.B. 633.

02. The Service does not issue advance rulings on the effect of the treaty on the tax laws of the treaty country for purposes of determining the tax of the treaty contry or the meaning of a treaty article for that purpose.

SEC. 11. EFFECTIVE DATE

This revenue procedure is effective 3 May 1982.

SEC. 12. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 70-18 and Rev. Proc. 79-31 are superseded.

CONFERENCE DIARY

SEPTEMBER 1982

36th Annual Congress of I.F.A.: I. The tax treatment of interest in international economic transactions. II. Taxation of payments to non-residents for independent personal services. Montreal (Canada), September 12-17 (English, French, German, Spanish).

Confédération Fiscale Européenne (C.F.E.): Third European Congress of Tax Consultants (including: State of tax harmonisation in Europe; The application of wealth taxes and taxes arising on death to foreign assets and liabilities; The practical application of international tax provisions (working groups)). Aachen (Germany), September 30 to October 2 (English, French, German, Spanish).

Management Centre Europe: International Compensation (Briefing) (including: The tax element in compensation planning). Brussels (Belgium), September 29 – October 1 (English).

OCTOBER 1982

Management Centre Europe: International Tax Management (including: Inter-company pricing of goods; inter-company licensing; service fees; inter-company loans; handling of disputes between tax administrations) (Seminar). Nice (France), October 11-12 (English).

NOVEMBER 1982

Management Centre Europe: 11th International Finance Conference: Changes in international finance and their implications for business (including: Financial and tax incentives aimed at attracting investments). Geneva (Switzerland), November 3-5 (English).

DECEMBER 1982

Management Centre Europe: Taxation of International Group Companies and Branches (including: Taxation of branches and subsidiaries; taxation of shareholders; domestic and tax treaty "anti-avoidance" measures) (Seminar). Brussels (Belgium), December 2-3 (English).

OCTOBER 1983

37th Annual Congress of I.F.A.: I. Tax avoidance/tax evasion. II. International problems in the field of turnover taxation. Venice (Italy), October 10-15 (English, French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

Confédération Fiscale Européenne (C.F.E.): Secrétariat Général, Postfach 1340, Dechenstrasse 14, D-5300 Bonn 1 (Federal Republic of Germany).

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.

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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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Part I. Tax policy and administration in Sub-Saharan Africa, by Carlos A. Aguirre, Peter S. Griffith, and M. Zühtü Yücelik.
Part II. A statistical evaluation of taxation in Sub-Saharan Africa, by Vito Tanzi.
Washington, International Monetary Fund, 1981. 73 pp.
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A guide for business and the professions.
Aldershot, Gower Publishing Company, 1982. 240 pp., £14.50.
Summary of the taxes on income and capital gains in Bangladesh, Botswana, Brunei, Burma, Cyprus, Egypt, The Gambia, Ghana, Hong Kong, India, Indonesia, Israel, Japan, Kenya, Korea (Rep. of), Lesotho, Libya, Malawi, Malaysia, Mauritius, Nigeria, Pakistan, Philippines, Saudi Arabia, Seychelles, Sierra Leone, Singapore, South Africa, Sri Lanka, Sudan, Swaziland, Taiwan, Tanzania, Thailand and Zambia.
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Gabon

MINKO, Henri.
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Bibliothèque Africaine et Malgache, Tome XXXV.
Paris, Librairie Générale de droit et de jurisprudence, 1981. 341 pp.
Study on the role of taxation in connection with the economic development policy in Gabon.
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1981/82 Cumulative supplement to Silke on South African income tax (ninth edition).
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Aldershot, Gower Publishing Company, 1982. 240 pp., £14.50.
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(B. 13.104)

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Annual publication on Asia and the Pacific. General assessments on the region concerning government, industry, construction and development, banking and finance, travel and tourism in general. Country by country information is appended.
(B. 51.904)

ECONOMIC AND SOCIAL SURVEY of Asia and the Pacific 1980.
Bangkok, United Nations, 1981. 143 pp., $11.
This survey is the 34th in a series of reports prepared annually by the Economic and Social Commission for Asia and the Pacific (ESCAP). A major object of these surveys is the analysis of recent economic and social developments in the region and of related international developments.
(B. 51.905)

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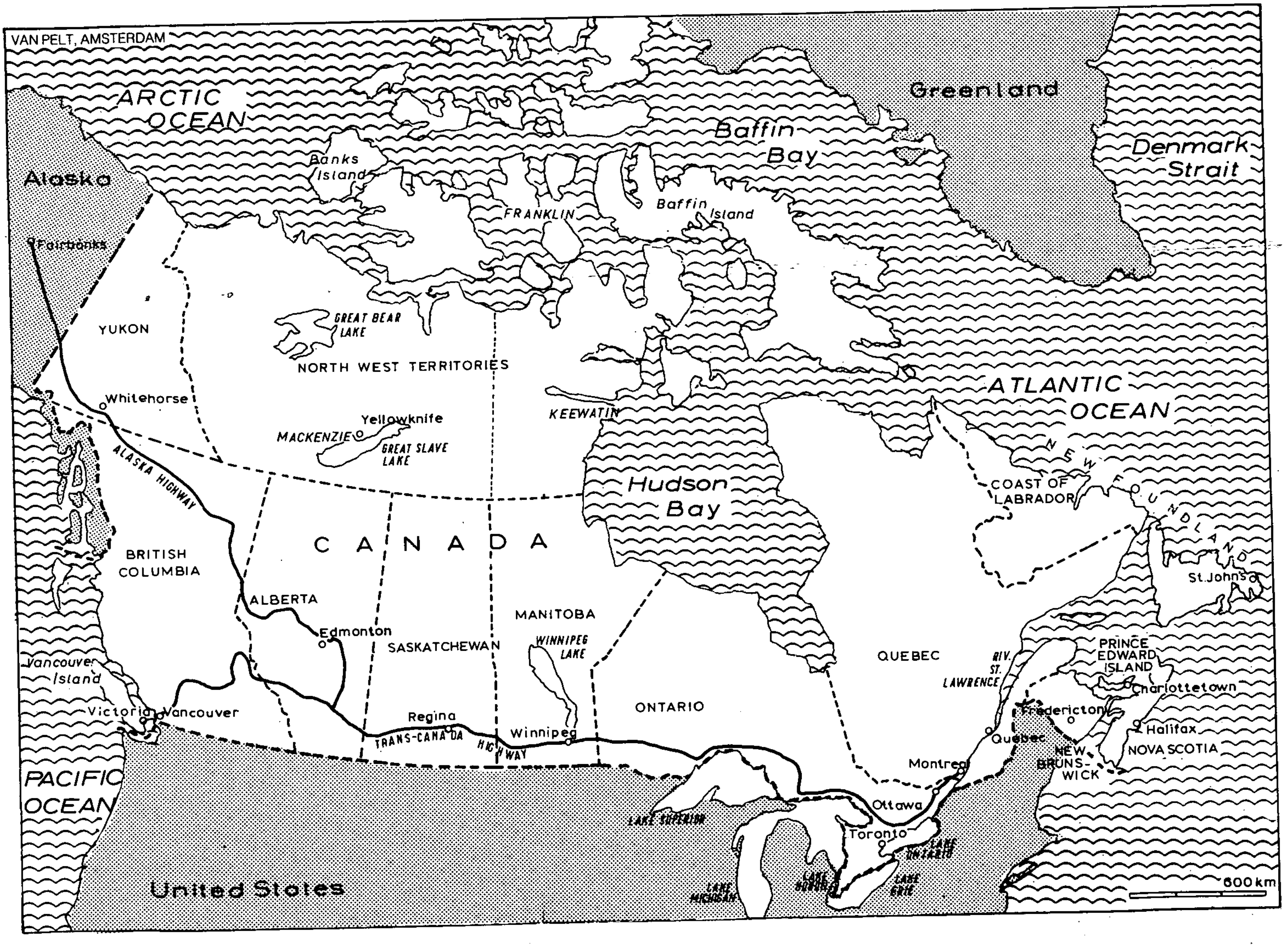


Congrès Montréal 1982

MAX LAXAN
Président de l'IFA

Appelé à BERLIN, l'an dernier, à succéder à Alun DAVIES, je m'adresse pour la première fois aux lecteurs du Bulletin de Documentation Fiscale Internationale et, à travers cette livraison spéciale, que chaque congressiste trouvera dans sa serviette, à l'ensemble des adhérents de notre association. Je voudrais tout d'abord saluer K.V. ANTAL, qui vient de quitter, après quinze années de dévotion à ses fonctions, la présidence du Curatorium du Bureau International de Documentation Fiscale et adresser mes voeux les plus sincères à son successeur, le professeur A. NOOTEBOOM, qui a été choisi pour lui succéder et dont j'ai eu plaisir à prononcer la nomination. C'est aussi pour moi l'occasion de souligner la grande qualité de la documentation et des études que le Bureau met à la disposition des fiscalistes du monde entier, sous l'active direction de J. VAN HOORN et de son équipe, pour le plus grand renom de notre association.

Je dois maintenant, selon l'usage, présenter aux lecteurs du Bulletin le programme de notre trente-sixième Congrès.

En 1981, nous avons tenu notre réunion à l'avant-poste du monde occidental, dans une ville qui est le témoignage vivant de la division de notre planète. Cette année, nous portant à quelques milliers de kilomètres à l'Ouest, nous tiendrons congrès, à l'invitation du groupement canadien, dans une des villes les plus attachantes du continent américain, et dans un pays jeune qui a su concilier avec bonheur les deux cultures dont il est dépositaire. Après les déchirements de la vieille Europe, le creuset de civilisations du Nouveau Monde . . .

Les deux thèmes d'études qui nous sont proposés revêtent un grand intérêt et une réelle actualité dans la mesure où ils concernent les deux facteurs principaux du développement des échanges internationaux, à savoir la circulation des capitaux et celle des hommes. Sans doute, à travers l'un et l'autre sujets, ne s'agit-il que d'un cas particulier de mise en oeuvre de ces facteurs. Cependant l'internationalisation croissante du financement des entreprises comme le développement des technologies modernes donnent aux problèmes qui seront traités à MONTREAL une importance et un relief certains.

Le premier sujet, je le rappelle, concerne le régime fiscal des intérêts des prêts dans les relations transnationales. D'intéressantes contributions ont été apportées à l'examen de cette question à l'occasion de congrès précédents. Je citerai par example les études relatives à l'imposition des entreprises apparentées en 1971, à l'égalité de traitement entre investisseurs résidents et étrangers en 1978 ou encore, l'an dernier, aux mesures unilatérales tendant à éviter la double imposition. Mais il était assurément utile de procéder à un examen exhaustif du problème et il faut savoir gré au Prof. HÖHN d'avoir magistralement ordonné, avec beaucoup de clarté, dans son rapport général, les différentes questions se rapportant au sujet et d'en avoir effectué une brillante synthèse.

La principale difficulté provient de la circonstance que la plupart des pays entendent percevoir un impôt à la fois sur le montant des intérêts versés à des non-résidents et sur les intérêts reçus par leur propres résidents. On assiste, de ce fait, à l'application simultanée du principe de la source et du principe du domicile. Dans la plupart des cas, et notamment entre pays industrialisés, ce conflit se résoud dans le cadre de conventions internationales qui organisent en quelque sorte le partage de la matière imposable entre les deux administrations fiscales intéressées.

Ce partage s'effectue le plus souvent dans des conditions conformes aux recommandations des conventions modèles de l'O.C.D.E. et de l'O.N.U. Dans ce cadre cependant, l'impôt payé à la source – et qui frappe le revenu brut – ne peut pas toujours être imputé en totalité sur l'impôt dû dans le pays de résidence, qui s'applique à l'intérêt net: il subsiste alors une double imposition partielle. A l'inverse, c'est une exonération partielle qui peut intervenir lorsque l'imputation forfaitaire excède l'impôt reèllement payé à la source, dans le cadre de relations entre pays développés et pays en voie de développement.

A défaut de conventions internationales, de nombreuses dispositions unilatérales portent remède à la double imposition des revenus des capitaux prêtés. En bref, les dispositions prises au plan international ou au plan interne assurent aux dispositifs fiscaux qui enserrent les mouvements de capitaux une neutralité assez satisfaisante et ne constituent pas un obstacle au financement des investissements.

Les difficultés résiduelles concernent plutôt l'exigence, pour l'élimination de la double imposition, de la conformité aux taux du marché de l'intérêt servi au créancier, notamment entre sociétés apparentées: l'assimilation des intérêts réputés excessifs à des dividendes peut conduire à une surcharge fiscale, surtout lorsque les conséquences de cette qualification ne sont pas entièrement reconnues par l'administration fiscale du pays du domicile.

Le second sujet soumis à nos réflexions concerne le régime fiscal applicable à la rémunération des services rendus par un non-résident dans le cadre d'une activité indépendante. Le dépouillement des vingt-quatre rapports nationaux et l'analyse très pertinente et très approfondie qu'a faite du sujet, sous ses différents aspects, le rapporteur général, M. Gérard COULOMBE, permettent de cerner très complètement les problèmes que peut rencontrer un prestataire de service exerçant ses activités dans un pays étranger. Il faut noter d'abord, dans les législations nationales, d'intéressantes convergences, spécialement en ce qui concerne les critères permettant de distinguer l'activité exercée à titre indépendant de celle exercée en qualité de salarié, même lorsque ces deux types d'activités sont développés de façon concomitante.

Par contre les conditions d'imposition des services rendus par un non-résident dans le cadre d'une activité indépendante varient considérablement d'un pays à l'autre. Aux deux extrêmes on relève la subordination de l'imposition à l'existence d'un établissement stable et, à l'inverse, l'extension de la taxation à tous les services rendus à un résident ou mis à sa charge. Mais on trouve, en fait, toutes les combinaisons possibles en fonction de l'endroit où le service est rendu, utilisé ou rémunéré. Les modalités d'imposition sont également très diverses, même si la pratique d'une retenue à la source est généralement observé.

L'application de la convention modèle de l'O.C.D.E., qui prévoit l'imposition au profit de l'Etat de la résidence des revenus de ce type, sauf si le contribuable dispose dans l'autre Etat de façon habituelle d'une base fixe, est d'une application de plus en plus générale, du moins entre pays industrialisés. De même, s'agissant d'artistes ou de sportifs, la conception plus extensive du droit d'imposer reconnue à l'Etat d'exercice de l'activité selon la même convention est largement suivie. De la sorte, le bon fonctionnement des conventions a réduit, de façon satisfaisante, le nombre des cas de double imposition. Il reste, comme le souligne le rapporteur dans ses propositions, qu'il serait souhaitable de parvenir à une harmonisation plus poussée des régimes d'imposition en vigueur dans les différents pays. D'autre part le caractère forfaitaire de certains prélèvements ne devrait pas excéder la capacité contributive réelle des prestataires de services.

La qualité des travaux présentés par les rapporteurs généraux, avec l'aide de leurs collègues nationaux, la rigueur de leurs analyses et le soin apporté à la formulation de leurs conclusions doivent permettre que s'instaure, à MONTREAL, sur les deux sujets retenus, un débat approfondi et enrichissant.

Pour compléter le programme, trois séminaires prendront place au Congrès de MONTREAL. Le premier développera les objectifs et les conséquences du système d'imputation et devrait donner lieu à des échanges de vues doctrinaux et pratiques des plus vifs. Le second mettra en lumière les aspects récents de l'évolution de la législation fiscale canadienne et sera l'occasion pour les participants de recueillir à la source une documentation du plus grand intérêt. Le dernier, enfin, traitera du projet de convention à intervenir entre le Canada et les

Etats-Unis: même s'il intéresse au premier chef les ressortissants des deux pays, il sera certainement suivi avec attention par un grand nombre de congressistes.

Il me reste à former des voeux chaleureux pour la pleine réussite, au plan scientifique comme au plan amical, du Congrès de MONTREAL.

The Congress of Montreal 1982

For the first time since I took over from Alun DAVIES in Berlin last year, I address the readers of the *Bulletin for international fiscal documentation*. Through this special issue, which everyone attending the congress will find in his congress kit, I also address all the members of our association.

First of all I would like to say farewell to Mr. K.V. ANTAL, who has just resigned as president of the Board of Trustees of the International Bureau of Fiscal Documentation after 15 years of dedicated work. I extend a hearty welcome to his successor, Professor A. NOOTEBOOM, who was chosen to succeed him and whose nomination I have ratified with pleasure. I also take this opportunity to emphasize the high quality of the documentation and studies that the Bureau, under the active guidance of Mr. J. VAN HOORN and his staff, offers tax experts all over the world, thus enhancing the fame of our association.

As usual, I will now present the programme of our 36th congress to the readers of the *Bulletin*.

In 1981 we held our meeting at one of the outposts of the western world, in a city which is the living witness of the division of our planet. This year we are holding our congress several thousand kilometers further west, at the invitation of the Canadian chapter, in one of the most attractive cities of the American continent and in a young country which has understood how to reconcile harmoniously the two cultures which it comprises. After the torn Old Europe, the cultural melting pot of the New World. . .

We are offered two subjects of great interest, which are especially topical as they concern two main factors in the development of international relations, namely the flow of capital and the movement of persons. In fact, both subjects show only a specific aspect of the operation of these factors. However, the increasing internationalization of enterprise financing as well as the development of modern technology invest the problems which will be dealt with in MONTREAL with an indisputable importance and significance.

The first subject concerns the tax regime of interest on transnational loans. At previous congresses interesting contributions have been made to the study of this matter. I would mention, for example, the studies on the taxation of related corporations in 1971, differences in fiscal treatment between local and foreign investors in 1978 and, last year, unilateral measures for the avoidance of double taxation. But it would certainly be useful to undertake an exhaustive study of the problem and we must be grateful to Prof. HÖHN for having arranged with great clarity the various questions on the subject in his general report and also for having brought about a brilliant synthesis.

The main problem arises from the fact that most countries want to receive taxes both on the amount of interest paid to non-residents and on the interest received by their own residents. Thus, the principles of source and domicile are simultaneously applied. In most cases, and especially between industrialized countries, this conflict is resolved through the conclusion of international conventions which provide for some kind of allocation of the income to be taxed between the two interested tax authorities.

This allocation is usually effected in conformity with the recommendations laid down in the model conventions of the OECD and the United Nations. However, notwithstanding the existence of tax conventions, tax withheld at source - which is imposed on the gross amount - cannot always be fully credited against the income tax which is due in the country of residence and which is levied on net interest: double taxation therefore remains to some extent. In contrast, where a fixed credit is granted which exceeds the tax actually withheld at source as is, for instance, often the case between developed and developing countries, there may be a partial exemption.

Where no international conventions exist, there are a great number of unilateral provisions which aim at remedying the double taxation of income from loan capital. In short, the measures which have been taken at international and national levels tend to ensure a satisfactory degree of neutrality and do not constitute an obstacle to the financing of investment.

Remaining problems concern, rather, the requirement that in order to obtain the elimination of double taxation, the rate of interest paid to the creditor must be in conformity with market conditions, especially in the case of parent companies: the labelling of interest deemed excessive as dividend may result in additional tax, in particular when such qualification is not fully accepted by the tax authorities in the country of residence.

The second subject which is submitted for our consideration concerns the tax regime applicable to the remuneration of services rendered by a non-resident carrying on independent activities. The General Reporter, Mr. Gérard Coulombe, has examined the twenty four national reports and his analysis, which is very relevant and very thorough, permits us to appreciate fully the problems which may beset a person supplying services and who performs his activities in a foreign country. It should in the first place be noted that there are interesting similarities in the national legislations, especially with respect to the criteria used to distinguish between independent and dependent personal activities, even where these two types of activity have developed concomitantly.

In contrast, the conditions under which services rendered by a non-resident in the framework of independent activities are taxed vary considerably from one country to another. There are two extreme positions: in some cases, the existence of a permanent establishment is a prerequisite for taxation whereas in other legislations tax is levied on all services which are supplied or charged to a resident person. However, one actually finds all kinds of possible combinations under which taxation may be based on the place where the service is rendered, utilized or remunerated. The manner in which taxation is effected also varies significantly, although in practice tax is generally withheld at source.

The application of the OECD Model Convention which prescribes that tax should be levied on this kind of income by the State where the recipient has his residence, except when the taxpayer habitually possesses a fixed base in the other State, is becoming more and more general, at least among industrialized countries. Also, with respect to artists and sportsmen, the more extensive concept to be found in the OECD Model Convention, under which the State where the activities are performed is permitted to impose tax, is now widely followed. Thus, a smooth functioning tax treaty network has satisfactorily reduced the number of cases of double taxation. As the General Reporter emphasizes in his suggestions, one problem remains which it is desirable to solve, i.e. a better harmonization of the tax regimes which are in force in the various countries. On the other hand, fixed withholdings should not exceed the capacity of persons supplying services to pay tax.

The quality of the studies presented by the General Reporters with the help of their national colleagues, the accuracy of their analyses and the careful formulation of their conclusions must result in a profound and rewarding discussion of the two selected subjects.

To round off the programme, three seminars will take place at the MONTREAL congress. The first will consider the aims and consequences of the imputation system and should provide an opportunity for a very lively exchange of theoretical and practical views. The second will shed light on the latest developments in Canadian fiscal legislation and will give participants the opportunity to obtain highly interesting first hand information. And last, the third seminar will deal with the new tax treaty which Canada and the United States are contemplating to conclude: even though it is of first and foremost interest to nationals of these two countries, this seminar will certainly be attended with interest by a large number of participants.

Let me finally express my warm wishes for a successful congress in Montreal, both on its scientific and social sides.

INTRODUCTION

With the advent of the 1982 IFA Congress in Montreal, it was considered appropriate to have some articles in the *Bulletin* commenting on the Canadian fiscal scene for the benefit of non-Canadian participants. To this end 5 papers have been assembled, each written by a separate and qualified fiscal expert. Each article covers a facet on the subject in terms which it is hoped will give the non-Canadian reader a useful overview of a field in which he may have an interest and yet also be sufficiently detailed and technically accurate to provide him with points of departure should he wish to study any particular area in greater detail.

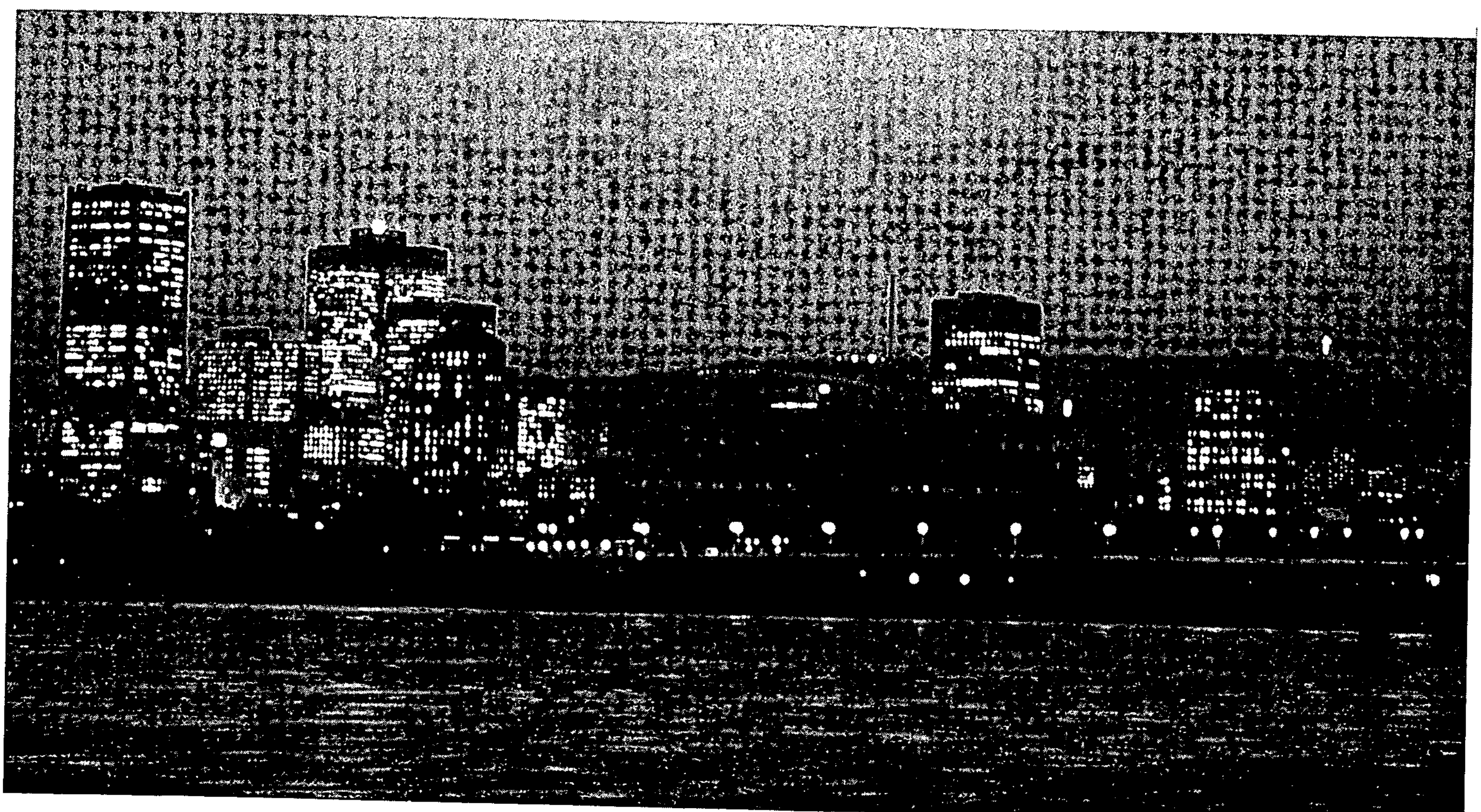
Two of the articles deal with doing business: one in Canada by non-residents ("Structuring Investments and Business Start-ups in Canada", by Nathan Boidman, a Montreal lawyer and international tax practitioner), the other doing business abroad by Canadians ("Taxation of Offshore Income and the Canadian Treaty Network", by H. Heward Stikeman, Q.C., also a lawyer practicing domestic and international tax law, based in Montreal and Toronto).

In addition to these rather specific articles, there are two more covering generalized fields: "The Influence and Impact of Canada's Tax Accounting Rules on Structuring Canadian Business Operations", by Edwin C. Harris, Q.C., a tax lawyer and lecturer in tax law at Halifax; and "Working with Canada's Statutory and Discretionary Industrial and Petroleum Assistance Program", by Peter McQuillan, C.A., a senior tax partner with Ernst & Whinney in Toronto. Mr. Harris's article deals with a subject that is important for any understanding of Canadian fiscal legislation: the growing divergence between the rules of tax accounting and the rules of public accounting. This divergence, which has been necessitated by the artificial structure of a so-called neutral tax system, often influences the choice of various courses of action in the commercial and financial world.

The article by Mr. McQuillan deals with the growing field of government grants and assistance programs which complement the fiscal system. These government programs either utilize the tax laws themselves or run parallel to them in such a fashion that any consideration of a problem based solely on the taxing statutes may be incomplete without a reference to and a knowledge of the various assistance programs that may affect it. Of particular importance, of course, is the recently introduced Canadian National Energy Program.

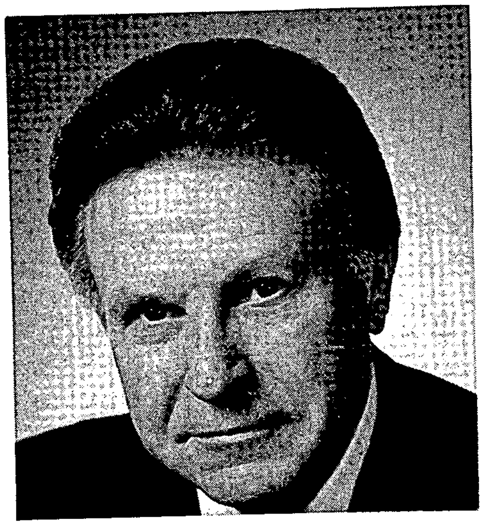
Finally we have been fortunate enough to obtain an article by the Federal Finance Minister, the Hon. Allan J. MacEachen, P.C. who describes how government fiscal needs and expenditure programs are developed. In particular he deals with the well known but recently introduced Envelope System of government budgeting and its impact upon tax expenditures and the rising of government revenue by fiscal measures.

It is hoped that this collection of articles will, within the covers of one small volume, provide a comprehensive view of the Canadian fiscal scene.



Integration of Tax Expenditures into the Government Fiscal Management System

by the Hon. Allan J. MacEachen
Deputy Prime Minister and Minister of Finance



Mr. MacEachen (61) received an M.A. from the University of Toronto.

He became professor of economics at St. Francis Xavier University at the age of 25.

Mr. MacEachen first entered federal politics in 1953.

In 1955, he attended the General Assembly of the U.N. as Parliamentary observer. He was alternate delegate in 1956 to the Economic and Social Council of the UN in Geneva.

In April 1963, he was appointed Minister of Labour. He, inter alia, piloted the Canada Labour Code through Parliament.

Mr. MacEachen was appointed Minister of National Health and Welfare in December 1965, and brought forward a series of major programs in the social security field.

Mr. MacEachen was Government House Leader in 1967-1968 and served as Chairman of the Committee on the Reform of Parliamentary Procedure.

In 1968 he was appointed Minister of Manpower and Immigration.

From 1970-74 he was President of the Privy Council and Leader of the Government in the House of Commons.

In August 1974, Mr. MacEachen became Secretary of State for External Affairs. He was responsible for the direction of Canada's effort at the Law of the Sea Conference. In June 1976, he announced the establishment of a 200-mile economic management zone for the continental shelf. Mr. MacEachen was also responsible for the Agreement on Commercial and Economic Cooperation between Canada and the European Economic Community. Between December 1975 and June 1977 he was co-chairman of the 27-nation Conference on International Economic Cooperation which was aimed at laying the basis for a more equitable world economic order. He also initiated Canada's successful bid for election to the Security Council of the United Nations.

In September 1976, Mr. MacEachen was appointed President of the Privy Council and Leader of the Government in the House of Commons. On September 16, 1977, Mr. MacEachen was appointed Deputy Prime Minister of Canada. He conducted the negotiations that led to the Northern Gas Pipeline Agreement with the United States in September, 1977 and subsequently piloted the Northern Pipeline Act through the House of Commons.

After the general election of February 18, 1980, he was appointed Deputy Prime Minister and Minister of Finance.

For the year 1980/81 Mr. MacEachen was appointed Chairman of the Group of Ten. In May 1981, Mr. MacEachen was elected, in Gabon, Chairman of the Interim Committee of the International Monetary Fund.

A proper fiscal management system is an important preoccupation of governments of most of the countries in the world. The principal objectives of a fiscal management system are to control the growth in public spending and to ensure an efficient allocation of public funds to various priority areas. It is also important that the system provide adequate opportunity for an ongoing review of the fiscal initiatives taken in the past, permit flexibility in shifting resources from one policy area to another in response to changing priorities, and provide for financial control.

To better achieve these objectives, Canada has recently adopted a new fiscal management system, under which the overall outlays of the federal government are divided into several broad policy areas or "envelopes". The spending decision within each envelope is then delegated to a committee of Ministers responsible for the policy areas within that envelope. While this system is similar in many respects to that found in some other countries, one unique feature of the system in Canada is the integration of tax expenditures or selective tax preferences within the system. This integration of tax expenditures into the system is in recognition of the fact that a variety of instruments may be used to achieve given policy goals. These instruments include grants, direct expenditures, loans and guarantees, and tax incentives. An appropriate fiscal management system should give a place to all of these alternatives so that the most appropriate mechanism is chosen. It should not bias the choice of instruments in a manner that is detrimental to the achievement of overall policy objectives.

THE ENVELOPE SYSTEM

The new fiscal management system, or the envelope system, as it is referred to, was adopted in response to a number of concerns that had developed over a period of years. The previous structure of federal government expenditure management presented certain difficulties which were articulated by successive Auditors General and by the government's Comptroller General. In November 1976 the government appointed the Royal Commission on Financial Management and Accountability, known as the *Lambert Commission.* The Commission's final report noted:

> Our review of the existing financial planning process revealed several fundamental weaknesses. None of the participants is held effectively accountable. Expenditures are proposed by departments in ignorance of projected revenues and without their being related to priorities. There is no public commitment to an expenditure plan and consequently no basis for effective parliamentary review. Finally, there is little public participation in expenditure planning.

Another important consideration was the effort by the Canadian government, like the governments of many other Western countries, to restrain the growth of the public sector. Expenditures since 1975-76 have been kept to an average growth rate slightly below that of GNP. This is reflected in the decline in the ratio of "total outlays", which is the sum of budgetary expenditures and non-budgetary loans, investments and advances, from 22.9% GNP in 1975-76 to 20.2% in 1980-1981. Such a period of restraint creates special pressures on a fiscal management system and highlights the need for an effective allocation of resources in relation to priorities including an effective review of existing programs.

The 1970s also saw rapid changes in Canadian society and many new issues facing governments. New government departments and agencies evolved and existing departments found more than ever that their responsibilities were intertwined with other policy areas. Clearly, this situation requires a high degree of budgetary control and a system that is designed to highlight trade-offs between competing programs.

The envelope system is intended to deal with the problems identified by ensuring greater Ministerial control over both policies and expenditures. The envelope system does this by assisting Ministers in integrating policy making and fiscal and expenditure planning within the Cabinet Committee system.

The outline of the basic system is quite straightforward. Its basis is a medium-term fiscal plan encompassing revenues and expenditures over a 5-year period. Each year, the Cabinet reviews the overall level of expenditures on recommendations by the Minister of Finance and President of the Treasury Board. These overall expenditures are then divided into 9 allocations for broad policy areas, or 9 envelopes as they are called. Formally, an envelope is an authorized expenditure limit, expressed in current dollars for the fiscal year in question. The 9 envelopes are Economic Development, Energy, Social Affairs, Justice and Legal, Fiscal Transfers to Provinces, External Affairs, Defence, Parliament, and Services to Government. A separate account is maintained for the costs of public debt.

Overseeing the operation of each envelope is a policy Committee composed of Cabinet Ministers with responsibilities in the policy area of the envelope. These committees have the responsibility of allocating expenditures within the envelope to particular departments and programs.

Each Policy Committee is provided with a basic operational level of expenditures within its envelope. This provides for the forecast cost of existing programs and an operating reserve to meet cost overruns, although the Treasury Board works throughout the course of the year to identify program savings to avoid net overruns in expenditures where possible.

Policy Committees may also be provided with additional amounts for the financing of new or enriched programs or they may be required to reduce expenditures. Policy Committees control the allocation of funds for new or enriched programs and designate existing programs that can be reduced or eliminated within their policy area.

The Policy Committees thus have two sources of funds for new or expanded programs. These are additional amounts provided for an envelope in the annual review by Cabinet and reallocation of amounts from existing programs. The incentive to identify programs that can be reduced or eliminated, thereby freeing funds for uses that are currently more in line with government priorities, is crucial to the system and makes it an effective means of fiscal management.

The foregoing represents a brief summary of the system in terms of expenditures. As was indicated earlier, this fiscal management system does not differ in broad outline from that used in some other countries. However, a unique feature of the Canadian system is its treatment of tax expenditures.

TAX EXPENDITURES AND THE ENVELOPE SYSTEM

The inclusion of tax expenditures in the fiscal management system is a very important feature and one that is of particular relevance in regard to the responsibilities of the Minister of Finance. The integration of the tax and expenditure sides of the budget reflects several considerations and experience gained in the period of restraint since the mid-1970s.

The basic concept of a tax expenditure is a provision in the tax system which provides certain taxpayers with preferential treatment in comparison to a benchmark tax structure. The benchmark tax structure is one that provides no preferential treatment to taxpayers on the basis of demographic characteristics, sources, or uses of income, geographic location or any other special circumstances applicable only to a given taxpayer or particular group of taxpayers. The preferential treatment or deviation from the benchmark may be in the form of deductions from income, exemptions, tax deferrals, lower tax rates or credits.

Tax expenditures are, in many respects, a substitute for direct spending. They both implement government priorities. As well, they both lead to increases in the budget deficits or require program cutbacks or increases in the general tax revenues for their financing. A proliferation of tax incentives eventually means higher tax rates for all because of a reduced tax base, which, in turn, has potentially serious implications for incentives to work, save and invest. Tax expenditures, just as direct expenditures, represent a form of government intervention in the economy. This, in itself, suggests that decisions about tax expenditures should be integrated into the fiscal management system.

Another consideration is that the size of tax expenditures is substantial, in both the number of items and the aggregate value of revenues foregone. In several policy areas they rival the value of direct spending. Moreover, tax expenditures were growing rapidly. From 1976 to 1979, the rate of increase in the value of tax preferences was some 50% higher than the rate of increase in direct spending.

It was perhaps not surprising that a period of rapid growth in tax expenditures coincided with increasing efforts to restrain government spending. Under the previous system additional funds directed to a policy area by tax expenditures did not affect the budget of the sponsoring department. With government expenditure restraint blocking all but the very highest priority new programs or expansion of existing programs from the mid-1970s, the introduction of new tax expenditures thus became one of the few avenues available for government program Ministers to pursue policy objectives that they quite legitimately identified in their areas of concern. It created strong incentives for each program Minister to seek new tax expenditures in his area of responsibility, usually with the support of the population groups or industrial sectors whose interests he or she was expected to represent. The Minister of Finance was placed in the lonely position of attempting to couple expenditure restraint with deficit reduction while maintaining the credibility of the tax system as a fair and effective means of raising government revenues.

The process of integration of tax expenditures into the fiscal management system comprises a number of elements. In the normal course of events, a program Minister would, initially, identify various alternative means of achieving a given policy objective and consider their relative advantages and disadvantages. These would then be reviewed by the relevant Policy Committee to determine if any policy action is warranted and if there are adequate funds set aside for it within the envelope. If it is the view of the Committee that the given policy objective is best achieved by a new tax expenditure item or extension of an existing one, the measure is then forwarded to the Minister of Finance who has the overall responsibility for the tax system. If the measure does not conflict with the basic objectives of the tax system or give rise to other structural or technical anomalies, then the Minister concurs with its adoption, and the cost of the measure is debited to the envelope for that policy area.

One crucial feature of this system is the concurrence of the Minister of Finance with the adoption of any tax measure. This is based on the need to maintain a tax system that operates in a fair and effective fashion. Unlike individual expenditure programs that can operate to a large extent almost independently of the other programs, the tax system is an integrated one. Changes in one part of the system may lead to repercussions elsewhere in the system. The Minister of Finance might not consider it desirable to proceed with a given tax change if, for example, it were to lead to significant difficulties in compliance and administration or give undue benefits to certain groups of taxpayers and thereby calling into question the fairness of the whole system. A tax incentive to one group or in respect of one activity might lead to pressures for similar incentives to other groups or in respect of other activities. It might sometimes be easier to resist such pressures when the incentive is provided through a direct expenditure program as opposed to the tax system.

Tax changes may also flow in the opposite direction, that is, the Minister of Finance may propose changes to a Policy Committee with the cost of the new tax expenditure to be charged to their envelope. Finally, the Minister of Finance may introduce changes on his own initiative for tax policy, fiscal policy, or administration grounds without giving rise to adjustments in envelopes.

In integrating tax expenditures into the financial management system, a key issue involves the treatment of existing tax expenditures. Should these existing tax preferences be assigned to envelopes and form a portion of the envelope entitlement? The decision taken was to exclude existing tax expenditures from the system.

While this may be considered a flaw in the implementation of the system, I believe it was a necessary and practical step that does not detract from the potential effectiveness of the system. First, the definition of a benchmark tax system against which to measure tax expenditures is far from a clear cut task. Commentators can differ sharply on such features as the appropriateness of using the individual or family as a unit of taxation, or assumptions about the integration of corporate and personal income taxes. When the tax expenditure accounts are for informational purposes, these questions of definition are not an obstacle to their presentation and use. They would, however, become of paramount importance if the full accounts were to be integrated into the fiscal management system. It was found that most of these issues arose in the context of existing tax provisions and that it was relatively easy to determine whether a new change was a tax expenditure or part of the benchmark structure.

The implication of this exclusion of existing tax expenditures is that their elimination or reduction does not provide additional amounts for an envelope, although the envelope could be credited by an appropriate amount where the Policy Committee recommends a cut-back in tax expenditures as part of a package to retarget fiscal incentives in a given policy area. In general, only tax incentives that have been provided for within the envelope system, i.e. new tax expenditures, will give rise to additional funds within when they are eliminated.

The integration of tax expenditures should have two direct influences on the frequency and the nature of tax proposals arising from program Ministers. First, program Ministers discuss the request for tax expenditures within their Parliamentary Committee as part of the actual budgetary process for their envelope, and thus should have vital interest in screening requests for tax expenditures coming out of the Committee. Second, since tax expenditures and direct expenditures both impact on the available amount of funds in an envelope, the decision to seek delivery through the tax system versus the expenditure system will be based on the relative merit of the two approaches.

The tax system may be a more advantageous way to carry out government policy for a number of reasons. First, the tax system is a self-assessment system and taxpayers themselves have the discretion to act on an incentive themselves. The degree of bureaucratic discretion and "red tape" is thus limited. Second, the tax system contains well-defined concepts and considerable information that, if used in delivering incentives, may simplify the process considerably. Finally, in the Canadian federal system, the tax system lends itself to joint federal and provincial action because income taxes are, in most cases, imposed on a common base.

However, there are also a number of negative consequences which may flow from the use of tax expenditures rather than direct expenditures. Tax incentives frequently have effects that run counter to maintaining the fairness of the tax system. For example, deductions from income are generally of more benefit to those with the higher marginal tax rates.

Tax expenditures, once put in place, have proved remarkably difficult to remove with their elimination always billed as a tax increase. Tax expenditures are thus likely to remain in place past the time when they are required. It is also difficult to determine the actual advantage of tax preferences to various groups in the economy as the number of such incentives multiply, because the incentives often interact with each other and may be offsetting.

Tax statutes need to be extremely precise because of the self-assessing nature of the Canadian tax system. With precision comes complexity and opportunities for tax planning activities which may reduce the amount of time and effort devoted to productive activity. The precision required also eliminates discretion, which in some cases may make a program much less flexible and responsive than is desirable. Finally, tax expenditures do not lend themselves to strict budgetary control. They must be available to all persons meeting the criteria established.

The new system adopted in Canada is designed to ensure that all these factors are given adequate consideration in the choice of instruments for achieving the given policy objective.

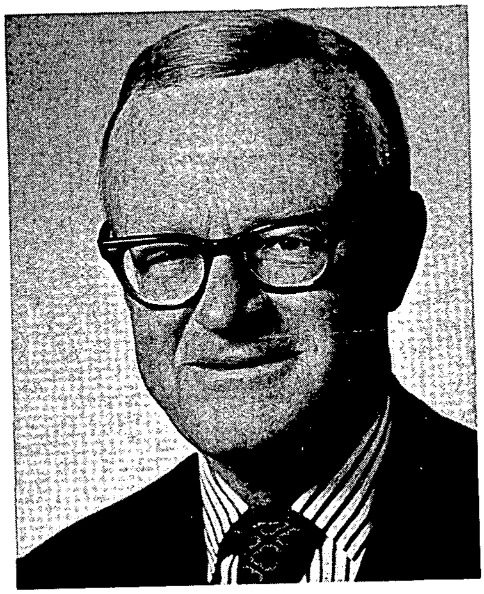
CONCLUSION

Canada has only recently adopted a system of fiscal management that incorporates tax expenditures. The system holds considerable promise in improving government decision-making, helping government in achieving fiscal restraint and ensuring that the most appropriate vehicle is used, whether that be the tax system, the expenditure system or loans and advances, when government intervention in the economy is desirable.

There are some very encouraging signs. Tax expenditures are taking their place in public and parliamentary debates. There is now generally more awareness of the limitations in the use of tax incentives for achieving policy objectives.

Taxation of Offshore Income and the Canadian Treaty Network

by H. Heward Stikeman



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Educated at Trinity College School and McGill University where he received his B.A. and B.C.L. in 1938. Mr. Stikeman served as Assistant Deputy Minister (Legal) to the Income Tax Division of the Department of National Revenue in Ottawa during the second world war. After leaving the post in 1946, he was appointed Counsel to the Committee of the Senate formed to study and recommend a reformation of Canada's income tax laws. In this position he was responsible for the redrafting of much of the new Income Tax Act that emerged after the war. Concurrently with this task, he joined the form of Foster, Hannen, Watt, Stikeman and Elliot. In 1952, he formed his own law firm which has since become Stikeman, Elliot, Tamaki, Mercier & Robb where he is continuing his practice in taxation and administration law. In 1969, the firm opened a European office based in London, England. Since that time, the firm has opened offices in Hong Kong and Ottawa. In 1971, he and Mr. Elliot joined with the Honourable John P. Robarts, on his retirement from the premiership of Ontario, and with Mr. D.G.H. Bowman, formerly Director of Tax Litigation of the Department of Justice, to form a parallel law firm in Toronto under the name of Stikeman, Elliott, Robarts & Bowman.
He is an ex-governor of the Canadian Tax Foundation, Editor-in-Chief of the many tax publications of Richart de Boo Limited in Toronto, a director of a number of Canadian companies, and a member of the Bars of Quebec and Ontario.

In his accompanying article, Nathan Boidman has dealt with the appropriate structures by which non-residents may start up businesses in Canada. Ed Harris in turn has shown how the tug of war between income tax law and the principles of public accounting has helped shape Canadian income tax patterns.

The foregoing articles leave open for consideration some areas in which Canadian taxation affects Canadians, corporations and individuals investing or carrying on business outside of Canada. Any examination of this facet of Canadian income tax law must take account of the part which Canada's international treaty network plays in influencing overseas investment decisions by Canadians.

Throughout Canada's principal taxing statute, the Income Tax Act, R.S.C. 1952, c. 148, as amended by S.C. 1970-71-72, c. 63 (hereinafter ITA), are scattered isolated provisions with specific relevance to international taxation. In addition, there are certain areas of the Act which address themselves only to non-residents.[1] These last are dealt with in the paper by Nathan Boidman. Other provisions of the Act are only concerned with Canadians having interests abroad.[2] Finally, there are provisions which, though they do not distinguish between residents and non-residents, are of great importance when dealing with the subject of international taxation.[3]

The federal budget of 12 November 1981 contained a number of proposals for the amendment of the ITA which, if ever implemented, will radically alter many of its provisions. Reference should be made to the paragraphs of the Notice of Ways and Means Motion to amend the Income Tax Act that accompanied the Budget.[4]

Canada also has a network of tax treaty relationships with other countries which must always be considered as part of its fiscal law. However, before becoming part of the laws of Canada, a treaty must be enacted as a statute, instruments of ratification be exchanged, and only then will the treaty take effect in accordance with its terms. Lord Atkin in *Attorney General for Canada* v. *Attorney General for Ontario*[5] says:

> 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, decide to incur the obligations of a treaty which involve alteration of law they have to run the risk of obtaining the assent of Parliament to the necessary statute or statutes. To make themselves as secure as possible they will often in such cases before final ratification seek to obtain from Parliament an expression of approval. But it has never been suggested, and it is not the law, that such an expression of approval operates as law, or that in law it precludes the assenting Parliament, or any subsequent Parliament, from refusing to give its sanction to any legislative proposals that may subsequently be brought before it.

1. Sections 2(3), 18(4)-(8), 19, 19.1, 20(11) & (12), 48, 69(2), 69(3), 81(1)(c), 85.1(3), 87(8), 88(3), 88.1, 114, 115, 116, 126, 133, 134, 190, 250, 253, 255, 257 Income Tax Act (ITA) and Parts XIII and XIV thereof.
2. Sections 90-95 and 113 ITA and Part LIX of the I.T. Regulations.
3. Sections 15, (56)2, 84, 88(2) and 214 ITA.
4. Resolutions No. 12, 14, 35, 51(a), 63-69, 95, 112, 114, 119 and 120. 1980 Budget Notice of Ways and Means Motion.
5. [1937] A.C. 326 at p. 347.

Contents

1. Branch or subsidiary?

Generally speaking, the Canadian taxpayer dealing abroad will be faced with the same type of decision which confronts a non-resident coming into Canada. The Canadian taxpayer will consider a number of factors, many of which have also been reviewed by Nathan Boidman in his parallel article from the viewpoint of a non-resident dealing with Canada. Moreover, certain considerations must be weighed as regards transfers between parents and subsidiaries, and Canadian and foreign business operations. The use of a foreign branch is unusual, however, and generally confined to situations involving an unprofitable overseas operation. The profits earned by the foreign branch are deductible. This ability to deduct losses has prompted the use of foreign branches by Canadians in launching businesses abroad. Likewise, Canadian companies have established foreign branches during the start-up years in which losses could be anticipated so that these losses serve to offset other Canadian income. If it is expected that the losses will continue indefinitely or that the operations in the foreign jurisdiction will be run on a break-even basis, the branch is probably the best approach. If a Canadian subsidiary is used, losses in start-up years can only be applied against income earned by the subsidiary. On the other hand a profitable subsidiary will pay less tax if foreign tax rates are lower than those of Canada.

2. Differences in tax structures

As long as the Canadian taxpayer is not earning a profit on his foreign business operations, differences in tax structure between Canada and the foreign jurisdiction are of little interest. As soon as the branch begins to turn a profit, however, the Canadian taxpayer may decide to incorporate it. This decision may be prompted by a variety of tax considerations:

(i) the tax rates on business profits may be more attractive in the foreign jurisdiction than in Canada and neither the Canadian small business deduction nor the deduction of manufacturing and processing profits can be claimed in respect of foreign operations;[6]

(ii) tax incentives available in foreign jurisdictions may not be available in Canada; and

(iii) tax costs associated with remaining in Canada can be reduced or even eliminated.

3. Tax consequences of incorporating foreign branch operations

It is not possible for a Canadian taxpayer to utilize the rollover provisions of Section 85 ITA to transfer assets to a corporation which is not a Canadian corporation[7] except in the case of a transfer of shares in a foreign affiliate to a corporation which, immediately following the transfer, was also a foreign affiliate of the Canadian taxpayer. The Canadian taxpayer interested in doing business abroad must, therefore, decide at the very beginning of his foreign operations what form he wishes them to take. A transfer of property to a foreign subsidiary will subject the transferor to immediate Canadian tax on recaptured amounts of depreciation, capital gains and proceeds for goodwill. Where, however, such a transfer would result in a loss to the transferor, even though a rollover would be denied if a profit were involved,[8] the transferor's capital loss is deemed to be nil. An amount equal to the capital loss "disallowed" or "not recognized" is added to the adjusted cost base of the shares of the transferee corporation controlled by the transferor. In the case of a labour-intensive enterprise, the Canadian taxpayer could conceivably close his branch, and, using a subsidiary, start up his foreign operation a second time. Another alternative would be for the Canadian to transfer the assets to a Canadian subsidiary, leasing them to the foreign branch. See, however, the possible effect of Budget Resolutions Nos. 64 and 65.[9]

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6. Sections 125, 125.1 ITA.
7. Paragraphs 89(1)(c) and 85.1(3) ITA.
8. Subsection 85(4) ITA.
9. Budget Resolutions Nos. 64 and 65.

(64) That

(a) subsection 85.1(3) and paragraph 95(2)(c) of the Act be amended to apply to a disposition of shares of a foreign affiliate of a taxpayer after November 12, 1981 only where the disposition is to a foreign affiliate controlled by the taxpayer,

(b) effective after November 12, 1981, a definition "foreign merger" be added to the Act similar to the definition of amalgamation in subsection (87)1 of the Act read without reference to the exception for a merger by means of the acquisition of property,

(c) effective after November 12, 1981, subsection 87(8) and paragraph 95(2)(d) of the Act relating to mergers of foreign affiliates of a taxpayer be amended to apply only to foreign mergers and be extended to apply to foreign mergers of other non-resident corporations,

(d) changes similar to those proposed in this Motion to subsection 87(4) of the Act made applicable to foreign mergers after November 12, 1981,

(e) a rule be introduced to allow a tax-free transfer of any capital property on a foreign merger after November 12, 1981 of two or more foreign affiliates of a taxpayer in each of which the taxpayer's equity percentage was at least 90% to form a new foreign affiliate in which the taxpayer's equity percentage was at least 90% where such property was transferred

4. Withholding tax

It should also be noted that Canadian withholding tax could be exacted from payments to non-residents made in the course of a branch business. This tax liability would be eliminated if the Canadian incorporated a foreign subsidiary.

5. Loan arrangements between Canadian parent and foreign subsidiary

When a corporation resident in Canada loans money to its non-resident subsidiary and the loan remains outstanding for a year or longer without interest at a reasonable rate having been included in computing the parent's income, interest at the rate of 16% per annum (as of 1 January 1982) on the outstanding balance will be imputed to the parent and taxed in its hands.[10] The lender can, however, escape imputation if it withholds tax on the amounts advanced.[11] When the loan is made to a subsidiary controlled corporation and the money is used in the subsidiary's business for the purpose of gaining or producing income, no interest is imputed to the parent.[12] If more than 50% of the voting shares of the subsidiary belong to the parent, the latter qualifies as a "subsidiary controlled corporation".[13] In a recent decision of the Tax Review Board, *Distillers Corporation - Seagrams Ltd.* v. *M.N.R.*,[14] it was held that the word "belong" in the definition of "subsidiary controlled corporation" must be interpreted as connotating "property" and consequently that the parent's control must be direct. See, however, the possible effect of Budget Resolution No. 14.[15]

In *Massey-Ferguson Ltd.* v. *M.N.R.*[16] the plaintiff loaned $1,000,000 to its wholly-owned Canadian subsidiary. The latter subsequently reloaned the money to its wholly-owned American subsidiary. The Federal Court, Trial Division held that the substance of the transaction was a loan from the plaintiff to a non-resident corporation. No legitimate business purpose explained the involvement of the plaintiff's subsidiary. Nor could the plaintiff claim the benefit of the exemption contained in Subsection 17(3) ITA: the borrower was not a controlled subsidiary corporation because the plaintiff's control was indirect. This decision was reversed by the Federal Court of Appeal: cf. *Massey-Ferguson Ltd.* v. *M.N.R.*[17] Despite the appellant's admission that the arrangement was set up to circumvent Subsection 18(1) ITA, the evidence disclosed that the parties intended to and did, in fact, create first a debtor-creditor relationship between the appellant and its subsidiary, and secondly, between the Canadian subsidiary and the latter's American subsidiary. There was no such relationship between the appellant and the non-resident. The Court concluded that the loaning of money to subsidiaries was a legitimate part of the Canadian subsidiary's business and neither its business nor its corporate existence was a sham.

It is Revenue Canada's position that when a Canadian corporation has loaned funds without interest to a wholly-owned subsidiary and the latter invests the fund in the capital of a subsidiary which it controls, interest will not normally be imputed to the Canadian corporation if the only undertaking of the wholly-owned subsidiary is financing its own subsidiaries by lending them money at interest, or subscribing for shares of their capital stock, on the condition that the funds are ultimately used by the borrower for the purpose of gaining or producing income from its business. The number of loans and the interest rate charged would generally be factors in deciding whether such activity was a business. If the wholly-owned subsidiary makes an interest-free loan to its subsidiary, interest will be imputed because these funds are not gaining or producing income.

If the Canadian parent borrows the money which it loans to its non-resident subsidiary, the interest payable is deductible under paragraph 20(1)(c) ITA. It must be em-

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free of foreign tax from the predecessor affiliates to the new affiliate,
(f) subsection 88(3) and paragraph 95(2)(e) of the Act relating to the liquidation of foreign affiliates of a taxpayer be amended to apply only to liquidations after November 12, 1981 of a foreign affiliate that was controlled by the taxpayer, and
(g) a rule be introduced to allow a tax-free transfer of any capital property on a liquidation after November 12, 1981 of a foreign affiliate of a taxpayer if the taxpayer's equity percentage in the foreign affiliate was at least 90% and the property was transferred free of foreign tax to another foreign affiliate of the taxpayer.

(65) That
(a) after November 12, 1981, the expression "excluded property" of a foreign affiliate be defined in the Act to mean property of an affiliate that is used in an active business of the affiliate, shares of the capital stock of another foreign affiliate all or substantially all of the property of which is excluded property and interests of the affiliate in partnerships, other than limited partnerships, in which the affiliate has at least a 10% interest where all or substantially all of the partnership property is used in an active business,
(b) any gain or loss of a foreign affiliate realized after November 12, 1981 with respect to indebtedness incurred for the purpose of acquiring excluded property be treated as a gain or loss from the disposition of excluded property,
(c) taxable capital gains and allowable capital losses of a foreign affiliate from the disposition after November 12, 1981 of excluded property (other than a disposition of shares to which paragraph 95(2)(c), (d) or (e) of the Act applies) be excluded from its foreign accrual property income,
(d) where at any time after November 12, 1981 a foreign affiliate disposes of shares of a second foreign affiliate that are excluded property (other than in a disposition to which paragraph 95(2)(c), (d) or (e) of the Act applies), an election under subsection 93(1) of the Act be deemed to be made in respect of such shares for a prescribed amount equal to the lesser of the proceeds of disposition and the amount that represents the portion of the net surplus of the second affiliate at that time that would be attributable to the shares sold if each foreign affiliate in which the second affiliate had an equity percentage had paid out its net surplus immediately before that time as a dividend, and
(e) a general anti-avoidance rule be introduced to deny the application of subsection 85.1(3) of the Act on a disposition after November 12, 1981 by a taxpayer of shares of a foreign affiliate, all or substantially all of the property of which is excluded property, to another foreign affiliate where the disposition is part of a transaction or series of transactions for the purpose of disposing of the shares to a person with whom the taxpayer deals at arm's length.

10. Subsection 17(1), ITA and Subsection 4300(5) of the I.T. Regulations.
11. Subsection 17(2) ITA.
12. Subsection 17(3) ITA.
13. Subsection 248(1) ITA.
14. [1980] C.T.C. 2737.
15. Budget Resolution No. 14:
(14) That for any period commencing after 1981, the provisions in section 17 of the Act be amended
(a) to extend the interest imputation requirement to any form of indebtedness regardless of its term,
(b) to remove the exception for loans to a subsidiary controlled corporation, and
(c) to require the imputation of interest at a prescribed rate on non-arm's length indebtedness.
16. [1974] C.T.C. 671.
17. [1977] C.T.C. 6.

phasized, however, that interest will only be imputed if the amount outstanding is actually a loan. Consequently, if the amount is owed under a creditor-debtor relationship, e.g. the balance owing on a purchase price, interest would not be imputed. Moreover, deemed interest will only be included in the parent's income so long as the lender-borrower relationship subsists. See, however, the possible effect of Budget Resolutions Nos. 12 and 23.[18] In the case of *Banister* v. *M.N.R.*[19] it was held that interest could not be imputed to the lender because the debt was validly extinguished according to provincial law.

In the provinces of Quebec and Ontario interest imputed to a parent company must be included in income whether or not the parent has paid tax on the amount of the loan under Part XIII of the federal Act.[20]

6. Inter-company pricing

A parent corporation, like any other party in a non-arm's length relationship, is required both to give and to receive adequate consideration when dealing with a subsidiary. Subsection 69(2) ITA provides that where a parent has paid or agreed to pay a subsidiary an amount for certain types of consideration which is greater than the amount that would have been reasonable in the circumstances if the two parties had been dealing at arm's length, then the reasonable amount only is deemed to have been paid. It should be noted that the criterion is not fair market value, but rather what would have been reasonable in the circumstances. The provision assures that the parent may not unreasonably reduce its Canadian income by way of overly large payments to its subsidiaries. Broadly speaking, this subsection is concerned with the price, rental, royalty or other payment paid or payable for use or reproduction of any property; consequently, payments for use and the actual price of property are both caught. Also included is any amount paid as consideration for the carriage of goods or passengers or for other services.

Subsection 69(3) ITA is the converse of Subsection 69(2) ITA and deals with payments by a non-resident subsidiary to its parent company. The enumeration of the types of payments involved is identical to that found above. Under this provision, where the amount is less than the amount which would have been reasonable in the circumstances if the non-resident payer and the payee had been dealing at arm's length, the reasonable amount is deemed to have been the amount paid or payable. Consequently, the parent may be forced to increase its taxable Canadian income in those circumstances.

However, the recent decision in the Federal Court of Appeal in *Spur Oil Ltd.* v. *The Queen*[21] would appear to give some support to the argument that so long as pricing is at fair market value or less, an arrangement entered into by the parties and clearly adhered to, though motivated by tax reasons, would not be artificial. See also *Dominion Bridge Company Limited* v. *The Queen.*[22]

The inter-company pricing rules are not a factor in determining whether a Canadian taxpayer doing business abroad selects a branch operation or incorporates a subsidiary. Rather, they affect the computation of branch profits if a branch operation is undertaken, as well as the incomes of both parent and subsidiary, if a second company is used.

7. Foreign tax credit and deduction of foreign taxes paid

Canadian residents who earn income from sources outside Canada may deduct, either wholly or partially, taxes paid to foreign countries from which their income is derived.[23]

There are a number of special rules for the computation and application of the foreign tax credit provisions that space prevents considering in this article.

8. Canadian taxation of profits of foreign subsidiaries – "The foreign affiliate rules"

For taxation years following 1975, a Canadian resident taxpayer must pay tax on his proportionate share of "passive" income (e.g. dividends, interest, rents, royalties, non-active business income and certain capital gains) earned by non-resident corporations and trusts which are or are deemed to be controlled foreign affiliates. The first $5,000 of passive income is exempted from Canadian taxation.

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18. Budget Resolutions Nos. 12 and 23:
(12) That for the 1982 and subsequent taxation years, the provisions of subsection 15(2) of the Act apply not only to loans but also to other forms of indebtedness and, where an amount owing by a person who is connected to a shareholder is to be included in income by virtue of that subsection, the amount be included in the income of the shareholder.
(23) That for the 1982 and subsequent taxation years, the provisions of the Act relating to the deduction of interest be amended to provide that in computing the income of an individual or a partnership.
(a) any interest expense otherwise allowable as a deduction in computing the income of the individual or partnership from property for a year (referred to in this Motion as "restricted interest expense") be deductible only to the extent of the income from property for the year.
(b) the individual or partnership may elect to treat as a capital loss for the year any portion of the restricted interest expense for a year that is not deductible in the year, and
(c) the amount by which the restricted interest expense of the individual or partnership for a year exceeds the aggregate of the amount thereof that was deductible for the year and the amount thereof that was treated as a capital loss for the year may be carried forward and treated as interest expense incurred in the following taxation year,
and for this purpose
(d) any benefit required by virtue of section 80.4 of the Act to be included in computing the income of an individual for a year will be treated as interest expense incurred by him in the year,
(e) except where all or substantially all the property of a partnership is used in an active business or a non-qualifying business, any interest expense incurred by an individual or partnership in a year on loans made to invest in the partnership will be treated as an expense incurred to earn income from property, and
(f) the restricted interest expense of an individual or partnership will not include interest incurred on a loan (other than a non-arm's length loan) the proceeds of which were used to finance the acquisition by it on or before November 12, 1981 of a residential rental building in Canada or at any time to refinance such acquisition.
19. [1973] C.T.C. 2036.
20. Subsection 14(5) of the Ontario Corporations Tax Act. Sections 126 and 127 of The Quebec Taxation Act.
21. [1981] C.T.C. 336. Editors note: See Alun G. Davies: "A spur in the side of Revenue Canada?" in 35 Bulletin (1981) at 531.
22. [1975] C.T.C. 263, 1977 C.T.C. 554.
23. Section 126 ITA.

The significance of foreign affiliates, other than "controlled foreign affiliates",[24] is limited to circumstances in which their shares are owned by Canadian resident corporations. Foreign passive income earned by non-controlled foreign affiliates is not taxable in Canada until distributed as dividends to Canadian resident corporate shareholders. Where dividends are paid out of the foreign affiliate's taxable surplus, the income is taxed in the hands of the resident Canadian corporation. Where, however, the dividends are paid out of either exempt surplus or preacquisition surplus, they are exempted from Canadian tax. Dividends received from non-resident corporations which are not foreign affiliates are taxed at full corporate rates. Dividends received from non-controlled foreign affiliates by individual shareholders resident in Canada are also fully taxable, with no deduction on account of foreign tax paid on the underlying earnings. Consequently, an individual with interests abroad can realize a tax saving by establishing a foreign affiliate and holding his shares in it through a Canadian corporation.

9. The rules of foreign accrual property income (FAPI)

The main thrust of the FAPI rules[25] is to deem a Canadian taxpayer, whether individual or corporate, who has a controlling interest in a corporation or trust outside Canada, i.e. a corporation or trust[26] which qualifies as a controlled foreign affiliate,[27] to have itself earned the foreign accrual property income, or FAPI, in excess of $5,000, of such controlled foreign affiliate.[28] As a result, Canadian taxation arises immediately, even if the income is not received by the Canadian taxpayer at that time. Related rules ensure that appropriate recognition is granted to other taxes already imposed on the income, and that the income is not taxed a second time if it is ever paid up to the Canadian taxpayer by way of dividend or otherwise. In addition, the rules elaborate a system for the taxation of dividends received from foreign affiliates which are not controlled foreign affiliates. See possible effect of Budget Resolution No. 66.[29]

A controlled foreign affiliate is defined[30] as a corporation which is not resident in Canada, and is controlled either directly or indirectly by the Canadian taxpayer, either alone or together with related parties, or with not more than 4 other persons resident in Canada, even if they be unrelated. A trust may also be a controlled foreign affiliate's FAPI, i.e. passive investment income, which exceeds $5,000 and which is included in the Canadian taxpayer's income for the taxation year in which the affiliate's taxation year has terminated.

FAPI is basically income for the year from property, or from a business other than an active business. Paragraph 95(1)(b) ITA contains detailed rules setting out certain specific types of income which are or which are not included in FAPI. The Act also contains rules respecting the computation of the foreign affiliate's income from an active business.

10. Inclusions and exclusions from FAPI

There is included in active business income, and hence excluded from FAPI,[31] any income from sources in a country other than Canada that might otherwise be income from property or a business other than an active business to the extent that it "pertains to or is incident to" an active business carried on by the affiliate. This "pertaining" rule presupposes that the affiliate is carrying on an active business in a country other than Canada. Interest earned by a construction company on securities put up to guarantee the performance of its contractual obligations is an illustration of the "pertaining" rule.[32] There is also excluded from FAPI any amount paid or payable to the affiliate by another foreign affiliate of the taxpayer to the extent that it is deductible from that other affiliate's earnings from an active business other than a business carried on in Canada.

If a controlled foreign affiliate earns income from services or an undertaking to provide services, that income is deemed to be FAPI if the relevant amount is deductible in computing the income from a business carried on in Canada by the Canadian taxpayer.[33] Services include the insurance of Canadian risks, but do not include the transportation of persons or goods or services performed in connection with the purchase or sale of goods. If a controlled foreign affiliate earns income from services or an undertaking to provide services, that income is deemed to be FAPI if the services are performed or are to be performed by an individual resident in Canada who controls the foreign affiliate. This provision is aimed largely at professional entertainers and athletes.

Foreign exchange gains realized by the foreign affiliate, by virtue of a fluctuation of the rate of exchange prevailing between the Canadian dollar and another currency, on the settlement of debts between the affiliate and another foreign affiliate of the Canadian taxpayer are excluded from FAPI.[34] Similarly, FAPI does not include any foreign exchange gain or loss arising on the redemption or non-arm's length disposition of the shares of a foreign affiliate of a Canadian taxpayer.[35]

FAPI does not include any of the following:

(a) interest received on certain debts created upon the sale or nationalization, prior to 18 June 1971, of Canadian-owned foreign public utilities;
(b) inter-affiliate dividends;
(c) taxable dividends deductible under Section 112 ITA; and
(d) taxable capital gains arising in respect of property used principally in gaining or producing income from an active business.

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24. Paragraph 95(1)(a) ITA.
25. Sections 90-95 ITA.
26. Subsection 94(1) ITA.
27. Paragraph 95(1)(a) ITA.
28. Subsection 91(1) ITA.
29. Budget Resolution No. 66:
That for the 1982 and subsequent taxation years, prescribed rules be provided to determine the foreign accrual tax in respect of an amount included in a taxpayer's income under subsection 91(1) of the Act where the foreign tax liability of two or more foreign affiliates of the taxpayer is determined on a consolidated basis or where in determining its foreign tax liability a foreign affiliate of the taxpayer deducts a loss of another foreign affiliate of the taxpayer.
30. Paragraph 95(1)(a) ITA.
31. Subparagraph 94(1)(b)(i) ITA.
32. Subparagraph 95(2)(a)(ii) ITA.
33. Subparagraph 95(2)(b)(i) ITA. Subsection 95(3) ITA.
34. Paragraph 95(2)(g) ITA.
35. Paragraph 95(2)(h) ITA.

On the other hand, most taxable capital gains, to the extent that they have accrued since 1975, are automatically included in FAPI. See possible effect of Budget Resolution 68.[36]

Apart from these statutory exclusions from and inclusions in FAPI, there is a middle ground. Here, income may fall to be either excluded from or included in FAPI, depending on whether the facts are such that an active business is or is not being carried on.

11. Active business income

Income from an active business is not FAPI but income from property and a business other than an active business is FAPI. The definition of "active business",[37] which adopts the meaning given for the purposes of the small business deduction,[38] is specifically restricted to corporations resident in Canada, and, therefore, does not apply in computing FAPI. Of assistance in understanding these concepts are IT-73R3, which discusses the meaning of "income from an active business", and the case law interpreting "active financial and commercial business" in somewhat different contexts.

In IT-73R3[39] the Department takes the position that once income is established as being derived from a business source, any appreciable activity expended in the actual income generating process of that business, other than usual housekeeping functions such as banking and record keeping, characterizes that income as income from an active business. As previously noted, income of any nature that is ancillary to the activities involved in carrying on a business is income from that business, notwithstanding the fact that it could be described as income from property or another source.

The determination of what precisely is active business income is one of the most perplexing in Canadian tax law. In *MRT Investments Limited et al* v. *The Queen*[40] the plaintiff and two other companies made mortgage investments on a comparatively small scale. MRT had no employees of its own but there were several persons who worked on behalf of the company and other companies in the group and these persons carried out significant investigations of investment opportunities. The Court was influenced by the fact that the making of investments was the very purpose for which the company was incorporated and the company did pursue its mortgage investment opportunities. The fact that the company did not pay salaries to its own employees or rent office space or equipment did not necessarily indicate that the companies were not carrying on an active business. The Court held that two of the companies were carrying on an active business by themselves, but that the third company did not carry on active business since it turned over the management of its investment to others without supervision or any direction in connection with its day-to-day operations. The decision in respect of the two successful companies was upheld in the Federal Court of Appeal and the decision in respect of the third company was reversed to hold that its income also constituted income from carrying on active business: *cf. The Queen* v. *Rockmore Investments Ltd., The Queen* v. *MRT Investments Ltd.* and *ESG Holdings Ltd.* v. *The Queen.*[41]

In *D.S.B.K. Management Ltd.* v. *M.N.R.*[42] a corporation which provided management services to a firm of chartered accountants was held by the Tax Review Board not to be carrying on an active business. The company received all its fees for management services related to the one firm of accountants. The judgment stated that the financial statements indicated little economic activity. The use of labour and capital was relatively insignificant, as no charge appeared in the financial statements for salary or wages. The statement was made that Parliament never contemplated this sort of activity carried on by the appellant as qualifying under Section 125 ITA for the small business deduction. However, on appeal to the Federal Court, the Minister granted the taxpayer's appeal by consent to judgment.

In *Cadboro Bay Holdings Ltd.* v. *The Queen*[43] the Federal Court, Trial Division, held that rental income received from a small shopping centre with 7 tenants represented income from an active business. The comment was made that in the absence of any indication in the Income Tax Act as to quantum of activity necessary for characterization as income from an active business, any quantum of business activity that gives rise to income in a taxation year for a private corporation in Canada is sufficient to make mandatory the characterization of such income as income from an active business carried on in Canada.

In *King George Hotels Limited* v. *The Queen*[44] the appellant operated a hotel but also leased certain properties to tenants. It was contended that the net rentals were income from an inactive business. The appellant was managed by JP Management Services Ltd., a company owned and operated by the same parties as the appellant. The net income from the rentals constituted 10% of the total net income of the appellant. The work in connection with the leased premises involved the employees of the management company for about one hour per month. The trial judge attributed these activities to the appellant, and the rental income qualified as income from an active business. It remained income from an active business when remitted to a third company in the group, Cavalier Enterprises Ltd. *Cf. Cavalier Enterprises Limited* v. *The Queen.*[45]

12. Computation of FAPI

FAPI is computed in accordance with the Income Tax Act, and not under the tax laws of the jurisdiction of the

36. Budget Resolution No. 68:
That effective after November 12, 1981, the capital gains and losses of a foreign affiliate of a taxpayer be calculated
(a) in Canadian currency in the case of property, other than excluded property, of a controlled foreign affiliate, and
(b) in the relevant foreign currency in all other cases,
and the provisions of paragraphs 95(2)(g) and (h) of the Act be applicable for all purposes of the Act.
37. Subsection 248(1) ITA.
38. Paragraph 125(6)(d) ITA.
39. IT-73R3 Information Bulletin issued by Revenue Canada.
40. [1975] C.T.C. 354.
41. [1976] C.T.C. 291, 294 and 295.
42. [1975] C.T.C. 2281.
43. [1977] C.T.C. 186.
44. [1981] C.T.C. 87.
45. [1981] C.T.C. 78.

controlled foreign affiliate's residence.[46] The calculation of certain capital gains and losses is excluded from this rule. In a given year, the FAPI of a controlled foreign affiliate is the aggregate of all of its FAPI less its foreign accrual property losses and its allowable capital losses for the year.[47] The FAPI of a controlled foreign affiliate for a particular taxation year may be reduced by the affiliate's deductible loss for that year and the 5 immediately preceding taxation years. FAPI is never a negative number. If a Canadian taxpayer has a controlled foreign affiliate with foreign accrual property losses, these losses may not be used by it to offset its income from other sources; nor can the negative passive income of one controlled foreign affiliate be used to offset the FAPI of another. On the other hand, the FAPI imputed to a Canadian resident corporation may be offset by that corporation's non-capital losses, and the FAPI imputed to a Canadian resident individual may be offset by his non-capital losses, and even by his allowable capital losses up to $1,000 per year.

A Canadian resident corporation disposing of shares in a foreign affiliate may elect to treat the proceeds of disposition as a dividend rather than a capital gain. Section 94 ITA applies the FAPI rules to offshore trusts. Section 95 ITA, in addition to containing the definitions of "controlled foreign affiliate" and "foreign accrual property income" discussed above, also sets out a special set of FAPI anti-avoidance rules and rollover provisions concerning the transfer of shares in a foreign affiliate on a share for share exchange, merger or distribution. See possible effect of Budget Resolution No. 64.[48]

The FAPI earned by a controlled foreign affiliate is attributed to the Canadian taxpayer in that taxpayer's taxation year in which the affiliate's taxation year ends. If a controlled foreign affiliate earns FAPI, the cost base of the Canadian taxpayer's shares in the affiliate must be adjusted,[49] but the adjusted cost base to a Canadian taxpayer of a share owned by him in a controlled foreign affiliate will be increased by the amount of FAPI which the Canadian taxpayer has been required to include in computing income.[50] Consequently, if the Canadian taxpayer disposes of the shares of the affiliate before receiving a dividend out of its FAPI on which he has been previously taxed, he will incur no further tax as a result of having realized a capital gain which reflects the amount of undistributed FAPI.

As far as corporate Canadian taxpayers are concerned, FAPI is included in the affiliate's taxable surplus.[51] Any dividend subsequently paid out by the affiliate is included in the corporation's income.[52] The corporation is, however, permitted to deduct underlying foreign corporate income tax ("foreign business income tax credit") and foreign withholding tax ("foreign non-business income tax credit").[53] The corporation may lastly deduct the remaining amount of the dividend if it is paid out of taxable surplus.[54] In this way, FAPI can be repatriated tax free and double taxation avoided.

Dividends paid after 1975 to a Canadian corporation out of the after-1975 active business income of a foreign affiliate, whether controlled or not, which is resident or carrying on business in a non-treaty jurisdiction, i.e. out of taxable surplus, are subject to Canadian income tax to the extent necessary to ensure that such income has borne tax which at least equals the Canadian tax level.[55] These dividends are included in the Canadian corporation's income when received by it, and the taxpayer is permitted to deduct

(a) the lesser of the relevant tax factor, i.e. 1/46% or 2.17391[56] minus 1, or 1.17391, times the underlying foreign corporate tax, or foreign business income tax, and the dividend, and
(b) the lesser of the relevant tax factor times the applicable foreign withholding tax, or foreign non-business tax[57] and the dividend less (a).

The full amount of a dividend to the extent that it is prescribed to have been paid out of the exempt surplus of a foreign affiliate may be deducted in computing the recipient Canadian resident corporation's taxable income.[58] Exempt surplus includes such items as capital gains not included in FAPI, post-1975 active business income earned in a treaty country, and pre-1976 earnings of all sorts net of tax.[59] Therefore, dividends paid out of the post-1975 active business income of a foreign affiliate resident and carrying on business in a treaty country are not subject to any Canadian tax.

Because of what is in effect a total exemption of dividends paid out of exempt surplus, no recognition is granted to the underlying income or profits tax and no foreign tax credit or other recognition is granted to the applicable withholding tax. Nor is the adjusted cost base of the Canadian taxpayer's shares in the foreign affiliate affected.

To the extent that a corporation resident in Canada receives a dividend out of a foreign affiliate's pre-acquisition surplus, the full amount of the dividend is deductible in the computation of its taxable income. A dividend is deemed to have been paid out of a foreign affiliate's pre-acquisition surplus when it no longer had exempt or taxable surplus.[60] Pre-acquisition surplus includes the earnings of a corporation accumulated at a time prior to the taxation year in which it first became a foreign affiliate of the Canadian resident corporation. The purpose of the exemption from Canadian tax of dividends paid out of this surplus is to permit its distribution to the Canadian corporation as a form of repayment of capital. This fact explains why paragraph 92(1)(b) ITA requires that the adjusted cost base of shares in a foreign affiliate be reduced by any dividends paid out of the pre-acquisition surplus.[61] Because of the effective exemption of dividends paid out of pre-acquisition surplus, no recognition

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46. Pararaph 95(2)(f) ITA.
47. Subparagraph 95(1)(b)(v).
48. Budget Resolution No. 64. See footnote 9.
49. Subsection 92(1) ITA.
50. Paragraph 53(1)(d) ITA.
51. Paragraphs 5907(1)(i) and (k) of I.T. Regulations.
52. Section 90 ITA.
53. Paragraph 113(1)(b) and (c) ITA.
54. Subsection 91(5).
55. Sections 90, 113 and 126 ITA.
56. Paragraph 95(1)(f) ITA.
57. Paragraph 126(7)(c) ITA.
58. Paragraph 113(1)(a) ITA.
59. Paragraphs 5907(b) and (d) I.T. Regulations.
60. Section 5901 I.T. Regulations.
61. Subsection 92(2) ITA.

or foreign tax credit is granted in respect of the applicable foreign tax or withholding tax.[62] There is also a further reduction in the adjusted cost base of shares of a non-resident corporation.

Section 5901 of the Regulations determines the order in which dividends are considered to have been paid out of the various surpluses of a foreign affiliate:

- exempt surplus;
- taxable surplus; and
- pre-acquisition surplus.

A deduction is permitted in respect of a dividend received by a corporation resident in Canada from a foreign affiliate to the extent that the amount of the dividend has not been offset by the other deductions that are permitted.[63] This deduction is limited to the adjusted cost base of the share on which the dividend is paid as at the end of the 1975 taxation year of the Canadian resident corporation. This deduction is optional, and basically permits the pre-1976 investment of the Canadian resident corporation in its foreign affiliate to be recouped as a return of capital. As the deduction is claimed, the adjusted cost base of the shares concerned is reduced.[64]

CANADA'S TAX TREATIES

Notwithstanding the complicated and detailed provisions of Canada's domestic tax laws as described in the foregoing pages, any dealing with the subject of foreign investment by Canadians would be incomplete without some consideration of Canada's tax treaties with foreign jurisdictions.

In general, Canada's tax treaties attempt to relieve from double taxation income derived by residents of one country from sources within the other. Such relief may be provided by two methods: in the case of investment income by imposing a ceiling on the rate of withholding tax that the source country may impose and in the case of other income or capital gains by limiting the instances in which the source country can tax such gains. Accordingly, Canadians doing business or investing abroad must be concerned with the degree of treaty protection available to them.

During the negotiation of a treaty it is always assumed that the contracting parties are aware of the existing internal laws and that the treaty was negotiated in light of them. Accordingly, references to the internal laws of the signatory powers as subsequently amended are usually avoided since this might afford the opportunity to one of the parties to change the treaty unilaterally by amending its own internal law. Section 2 of the Protocol to the U.S.-Canada treaty foresees the possibility of change in internal law, and provides for a mechanism by which the provisions of the Treaty can be modified, if desired by the parties, in light of such changes. Section 2 of the Protocol to the Convention states:

> In the event of appreciable changes in the fiscal laws of either of the contracting States, the Governments of the two contracting States will consult together.

See also *Associates Corporation of North America* v. *Queen*.[65]

In Canada, therefore, treaty provisions override domestic law, past and future. In *Hunter Douglas* v. *The Queen*[66] the issue was whether the plaintiff should have withheld tax on dividends paid non-resident shareholders. Under the Income Tax Act, the plaintiff corporation was clearly resident in Canada and thus obliged to withhold tax on dividends paid to non-resident shareholders. Under Netherlands law, however, it was resident there. Due to a provision in the Canada-Netherlands tax treaty which deems a corporation to be solely resident in the country where its central management and control is located, if that country is either Canada or the Netherlands, the Federal Court found the plaintiff, on the facts, to be resident in the Netherlands. The Minister submitted that the plaintiff's Dutch residence should only be recognized in respect of its Dutch shareholders. The Federal Court, however, concluded that the treaty provisions overrode the definition of residence found in the Canada Act, regardless of the residence of the payees.

In Canada both the English and the French versions of a treaty are official.

Although the paramountcy of Canada's tax treaties is generally made explicit in Canada's enabling legislation, one should not assume, however, that such a result prevails generally. In the United States, for example, subsequent legislation can override existing treaties.

Canada's new treaty with the United States was initialled on 26 September 1980. It has not yet, however, been ratified by the American Senate, nor is the necessary enabling legislation before the Canadian Parliament. There are expectations that it will become law before the end of 1982. Canada's new treaty with West Germany, initialled on 17 July 1981, is not yet effective. Besides these treaties, Canada has more than 50 treaties or double tax agreements in force or under negotiation.

The renegotiation of the American treaty and the long years taken to reach agreement underline a problem that affects international businessmen everywhere: how to keep a treaty in step and current with domestic fiscal developments within the signatory countries. Business and investment cannot afford to wait out the potentially long delays between treaty amendments. Fortunately, however, tax treaties are anomalies in the fiscal system, and, unlike taxing statutes, they usually contain provisions known as "competent authority provisions" permitting the direct negotiation of administrative or interpretational problems between the government of Canada and the governments of other jurisdictions at non-political levels. Such provisions permit of a practical and non-technical approach to treaty problems without recourse to the courts. Largely as a result of the success of this approach over the years, under the U.S. treaty the concept of the "competent authority" approach has been elevated to an accepted general practice which has achieved a formalized structure and considerable efficiency.

In order to invoke the consultative or "competent authority provisions" such as that contained in Article XVI

62. Paragraph 53(2)(b) ITA.
63. Subsection 113(2) ITA.
64. Subsection 92(3) ITA.
65. [1980] C.T.C. 80.
66. [1979] C.T.C. 424.

of the U.S.-Canada income tax convention, the taxpayer needs to "show proof" that he has suffered double taxation as a result of "the action of the Revenue authorities of the contracting States" and lodge a claim. If the claim "should be deemed worthy of consideration", the "competent authority" of one state may consult with the other. Unfortunately "double taxation" is itself a fuzzy idea. The administrative tendency has been to restrict the notion to the taxation of the same gain in the same hands by two jurisdictions. Taxing the same economic benefit in different hands is not usually considered double taxation. However, in the light of Canada's attempt to shape new treaties on the O.E.C.D. model wherever possible, the double taxation relief may be enlarged, and inroads on treaty protection by the administrators or legislators of the signatory countries may be contained.

PROVINCIAL TAXATION: QUEBEC

Quebec's Taxation Act,[67] which levies income tax on both individuals and corporations, follows the Income Tax Act in many ways, but for constitutional reasons does not impact on certain areas of international taxation. In particular, Quebec does not levy withholding tax on payments to non-residents. The Quebec Taxation Act has no equivalent to Parts XIII and XIV of the federal Act. It should be noted, however, that Quebec respects the treaty arrangements entered into between Canada and other jurisdictions and will not include in income, for Quebec tax purposes, amounts which are specifically exempted from federal income tax pursuant to a treaty provision.[68]

PROVINCIAL TAXATION: ONTARIO

Ontario levies a provincial income tax on corporations only under the Ontario Corporations Act.[69] Unlike Quebec, however, it does not uniformly respect treaty arrangements concluded between Canada and foreign jurisdictions. A Canadian corporation having a permanent establishment in Ontario is liable to tax.[70] In the case of corporations incorporated outside of Canada, liability to tax arises in any of the following circumstances:

(a) the existence in Ontario, whether in the year or any previous year, of a permanent establishment;
(b) the ownership, whether in the year or in any previous year, of real property, timber resource property or a timber limit in Ontario from which income is derived from the sale or rental thereof or from royalties; or
(c) the disposition in the year or any previous year of property situate in Ontario that was "taxable Canadian property" as defined.[71]

Comparable provisions are found in Ontario law.[72]

If, however, the corporations were incorporated in a jurisdiction with which Canada has entered into a tax treaty, it is not required to pay tax in respect of its rental and royalty income unless it has elected to pay tax under Part I ITA as a resident rather than under Part XIII.[73] Capital gains realized in connection with real property are also exempt from Ontario taxation.[74] Moreover, the Ontario Corporations Tax Act Regulations[75] provide that where no federal income tax is payable on a disposition of taxable Canadian property because of an exemption in the applicable treaty, property otherwise situate in Ontario is deemed not to be situate there for purposes of Ontario tax and thus not taxable by Ontario. Consequently, all capital gains realized by a non-resident corporation which are exempt from federal tax under a tax treaty are also exempt from Ontario tax, provided that the corporation does not otherwise have a permanent establishment in Ontario.

It should also be noted that the meaning given by Section 5 of the Ontario Act to the term "permanent establishment" is not precisely the same as that given the expression in Part IV of the federal ITA Regulations. Unless it maintains a permanent establishment elsewhere in Canada, a corporation is regarded as having a permanent establishment in Ontario if its head office or registered office is located there.[76]

PROVINCIAL TAXATION: ALBERTA

The Alberta Corporate Income Tax Act[77] became law on 22 May 1980 with effect after 31 December 1980. The tax levied under the Alberta statute is based on taxable income as determined under the federal Act, i.e. the taxable income declared in the corporation's federal return. Such taxable income is then adjusted to take into account existing and new tax incentives. The corporation must, however, file a separate Alberta tax return. While as yet uncertain, it is doubtful whether this new legislation will give rise to any problems.

PROVINCIAL TAXATION: OTHERS

The remaining provincial income taxes are levied as a percentage of the federal tax payable, and are collected by Revenue Canada. The possibility of conflicting federal and provincial provisions has accordingly been effectively eliminated.

SOME TREATY PROBLEMS

As a practical matter, there are really only a few areas that regularly cause trouble in the interpretation of treaties. For example, many treaties define "permanent establishment" and "industrial or commercial profits"

67. L.R. Quebec 1977 c. I-3.
68. Section 488R1, Quebec Taxation Act Regulations.
69. Revised Statutes of Ontario 1980 ch. 97.
70. Subsection 2(1), Ontario Corporations Tax Act.
71. Subsection 248(1) ITA.
72. Subsection 2(2) Ontario Corporations Tax Act.
73. Paragraph 2(3)(b) ITA.
74. Subsection 29(2) ITA.
75. Subsection 717(2), Ontario Corporations Tax Act Regulations.
76. Subsection 5(11) Ontario Business Corporations Act.
77. Statutes of Alberta, 1980 ch. 10.

but the definitions are not always given the same effect. This is because both definitions can be somewhat artificial and may vary from treaty to treaty, sometimes deviating from the commercial meaning of the same words used in ordinary business parlance. It is important, therefore, in order to determine the taxability of industrial and commercial profits that may be attributed to a permanent establishment, for a businessman to examine carefully the terms of the particular treaty. He may find that the words "industrial and commercial profits" are not necessarily the same as income as defined in the local laws of the signatory countries. In the case of the Canada-U.S. treaty, for instance, certain items have been excluded which in ordinary business usage would be included in the meaning of industrial and commercial profits: e.g. royalties, interest, rents, dividends, management charges and capital gains.

REALLOCATION OF INCOME

In all of Canada's tax treaties with other countries, except that with Jamaica, special provisions exist relating to the allocation or reallocation of income between related corporations.

The key provision in Article IV of the Canada-U.S. tax convention[78] and similar ones in other treaties is that adjustment to profits may be made by disregarding conditions "made or imposed by the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises". There does not seem to be any real inconsistency between these provisions and those found in Subsections 69(2) and (3) of the Canadian Tax Act which purport to tax an amount that is "reasonable" in the circumstances if the non-resident person and the taxpayer had been dealing at arm's length. These provisions are most often involved in challenges by one of the contracting states against transfer prices charged by an entity of the other state. For example, in Article IX of the French treaty with Canada there is incorporated the associated enterprise rule contained in Article 8 of the Canada-U.K. tax agreement. Under this rule, commercial or financial relations between associated enterprises (as defined), different from those which would be made between independent enterprises, may be looked through by the national taxing jurisdictions.

The French treaty, however, adds a welcome relieving provision. Where the profits of an enterprise are altered by virtue of this rule with the effect that double taxation results, an automatic counterbalancing adjustment is provided in the other state. Furthermore, the initial adjustment made to the profits of one of the associated enterprises cannot be made "after the expiry of the time limits provided in the national laws" and in any case not after 5 years. This provision will prevent, for example, a readjustment by Canada of the profits of a Canadian establishment of a French enterprise beyond the 4-year reassessment limit under the Canadian Act. Following the wording[79] of the Canadian Income Tax Act this time bar does not apply in the case of fraud or wilful default. Generally this aspect of the French treaty seems workable and certainly superior to, for example, Article IV of the U.S. treaty under which adjustments to meet the initial reassessment require competent authority action, and without any protection against time-barred situations.

There may well be a problem as to the exact legal remedies available to the controlled Canadian resident corporation in the event of additional tax being levied by Canada by reallocating income to it on some basis not authorized by a tax treaty. A claim for relief under Article XVI of the Canada-U.S. convention, for example, with possible competent authority action, applies only with the government of the country in which the corporation is incorporated and then only if the taxpayer shows proof that it has suffered double taxation. In other treaties, such as that with the United Kingdom,[80] in order for a claim for relief to be lodged it need only be shown that the action of the taxation authorities of the contracting government has resulted, or will result, in taxation contrary to the provisions of the convention. Under these treaties, it is not necessary to show that the taxpayer, by itself, has suffered double taxation.

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78. Article IV, Convention between Canada and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion in the case of Income Taxes, effective January 1, 1941:
1. (a) When a United States enterprise, by reason of its participation in the management or capital of a Canadian enterprise makes or imposes on the latter, in their commercial or financial relations, conditions different from those which would be made with an independent enterprise, any profits which should normally have appeared in the balance sheet of the Canadian enterprise but which have been, in this manner, diverted to the United States enterprise, may be incorporated in the taxable profits of the Canadian enterprise, subject to applicable measures of appeal.
(b) In order to effect the inclusion of such profits in the taxable profits of the Canadian enterprise, the competent authority of Canada may, when necessary, rectify the accounts of the Canadian enterprise, notably to correct errors and omissions and to re-establish the prices or remuneration entered in the books at values which would prevail between independent persons dealing at arm's length. To facilitate such rectification the competent authorities of the contracting States may consult together with a view to such determination of profits of the Canadian enterprise as may appear fair and reasonable.
2. The same principle applies, mutatis mutandis, in the event that profits are diverted from a United States enterprise to a Canadian enterprise.

79. Subsection 152(4) ITA.

80. Article 24, Convention between the Government of Canada and the Government of the United Kingdom of Great Britain and Northern Ireland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains:
ARTICLE 24
Exchange of information
1. The competent authorities of the Contracting States shall exchange such information (being information which is at their disposal under their respective taxation laws in the normal course of administration) as is necessary for the carrying out of the provisions of this Convention or for the prevention of fraud or for the administration of statutory provisions against legal avoidance in relation to the taxes which are the subject of this Convention. Any information so exchanged shall be treated as secret and shall not be disclosed to persons other than persons (including a court or administrative tribunal) concerned with the assessment, collection or enforcement in respect of the taxes which are the subject of this Convention. No information as aforesaid shall be exchanged which would disclose any trade, business, industrial or professional secret or trade process.

PRACTICAL QUESTIONS FOR THE BUSINESSMAN-INVESTOR

Basic questions that should be asked by Canadians contemplating foreign investment are the following:

1. If I do make profits abroad, can I bring them home?

2. Can I withdraw my capital from the foreign jurisdiction at will or are there exchange regulations or fiscal or security provisions that would make it more difficult than if I made the investment in Canada?

3. Will I suffer double taxation by investing abroad?

4. Will profits abroad be treated as capital or income gains and are the rules for the determination of capital gains vs. income the same as those at home or will I be whipsawed by different definitions on either side of the border?

5. Can I compute my income from the offshore source by the same accounting standards and with the benefit of the same reductions for cost and depreciation as would be applicable if the gain were to be made at home? If I cannot, will one jurisdiction accept the rules applied by the other in its assessment of my gains or income? On this point see the accompanying article by Edwin Harris.

6. Alternatively, is there a risk that income might be computed differently abroad so as to reduce the benefit of tax credits or other offsetting provisions at home?

7. Will I be treated any worse than a resident of the jurisdiction in which I propose to invest or do business because I am a foreigner or a non-resident or a Canadian?

8. What remedies do I have through the courts in Canada or by virtue of the competent authority provisions in the relevant tax treaty if I have trouble with the provisions of the treaty as it may apply to my venture?

U.S. TAX ON REAL PROPERTY GAINS BY FOREIGNERS

Of particular importance to Canadians investing in the U.S. is the recent legislation by the U.S. imposing a capital gains tax of 28% upon the disposition of real property or any interest therein, including shares in a company owning real property, where the property was disposed of by a non-resident of the U.S. At the moment, Article VIII of the present Canada-U.S. treaty protects gains realized in one jurisdiction by a resident of the other from capital gains tax imposed by the country in which the gain arose. While this protection will be removed under the new treaty, it will still give Canadian investors a step up on their cost for purposes of computing the U.S. capital gains tax. The cost base will be the value of the real property as of the effective date of the new treaty. There will be thus for Canadians two valuation days – 1 January 1972 for all capital property save U.S. real estate, and the date of coming into force of the new Canada-U.S. treaty for the latter.

On reviewing the complicated and sometimes confusing rules that govern Canadian taxpayers as set out in this short series of articles, the non-Canadian reader might be pardoned for wondering how the Canadian business and investment community manages to cope and survive. The answer is by dint of much effort and application of time and intelligence. Over the years, Canada's fiscal system, under the guise of a series of ongoing "tax reforms", has become more confining and introverted and places a heavier burden and more severe penalties on initiative and foreign capital formation. This in turn imparts upon Canada's competitive abilities in the international commercial and financial world. The only mitigating force is the treaty network with other countries, which is why I have given it some prominence in this article.

Structuring Investments and Business Start-ups in Canada

by Nathan Boidman

I. INTRODUCTION

The advent of the 1982 I.F.A. Congress in Montreal is occasion to review the taxation parameters[1] of foreign investment in Canada, in general, and the impact thereon of recent developments,[2] in particular. The focus of this article will be the general tax considerations at the time of making the investment or acquiring or starting up a Canadian business, that is, "structuring" from the taxation standpoint.[3]

The initial structure normally establishes or fixes the manner in which Canadian tax will apply and, although re-structuring or reorganization at a later time may sometimes be feasible, it is usually possible and preferable to achieve the optimum structure from inception. For example:

- Whereas direct foreign ownership of Canadian real estate cannot be transferred subsequently to a corporation on a tax-free (rollover) basis, other types of directly held investments or business properties normally can be "rolled over" to a company formed under Canadian law.[4]
- An initial investment through a Canadian corporation[5] cannot be unwound on a tax-free basis in order to achieve direct foreign holding of the properties initially owned by the Canadian corporation.[6]

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Since 1974, Mr. Boidman has restricted his practice to consulting in tax matters: he has authored numerous articles and papers on international tax and lectures frequently on the topic. Mr. Boidman, a member of the tax management advisory board on foreign income is contributing and consulting editor to several international tax journals and newsletters and is completing a book on treaty interpretation in Canada, and one on the impact of recent domestic tax law and treaty changes on structuring Canadian investment in U.S. real estate scheduled for publication in 1982, by CCH Canadian Limited; as well Mr. Boidman is co-authoring a book on taxation of foreign investment in Canada, to be published in 1983 by Kluwer.

1. The scope of this article is income taxation which is imposed by the Canadian Federal Government through the Income Tax Act, C.63 - 1970-71-72-73, as amended (herein the Act or I.T.A.) and by each of the 10 provinces through largely parallel legislation. The interplay of Federal and provincial law will be seen in various contexts below. Canada does not levy gift, estate, succession or inheritance taxes at either the Federal or provincial level except in the case of the Province of Québec; however, Canadian income taxes can arise at death in respect of unrealized appreciation of value of property. Retail sales taxes are levied at the provincial level while custom duties, excise and tax on manufactured goods are levied by the Federal Government, and in some areas by the provincial governments; these are beyond the scope of the article.
2. The impact of the Federal Government's 1980 National Energy Program on the oil and gas industry has been widely chronicled. In November 1981, the Federal Budget contained proposals for sweeping taxation changes, some of which will be seen in this article; however, at time of writing, detailed legislation in respect thereof had yet to be tabled in Parliament or published in draft form. Uncertainty brought about by unprecedented lobbying by various interested groups (business, etc.) and the broad imprecise language in which some of the proposals were couched (in the "Notice of Ways and Means Motions" which was tabled with the Budget) make it difficult to assess the full impact of the Budget on foreign investors.
3. The accompanying articles by Edwin Harris and Peter McQuillan address Canadian tax considerations of ongoing business operations, once structured and in place. Heward Stikeman's article on Canadian taxation of foreign investment by Canadians will be of interest to foreign investors considering Canada as a base for investment in third countries, such perhaps arising in respect of the redeployment of retained profits of foreign-owned Canadian subsidiaries.
4. Section 85 of the Act permits taxpayers to "roll over" most types of properties without recognizing appreciation in value, provided appropriate formalities (elections) and rules are complied with. However, foreign investors (that is, persons who are not resident in Canada) cannot transfer Canadian real estate under the protection of section 85.
5. "Canadian corporation", in this context, is one which is a resident in Canada. A company is resident in Canada if it has been formed under Canadian corporate law (Federal or that of a province) after 25 April 1965 or, where formed in another jurisdiction, has its "central mind and management" exercised in Canada - a case law doctrine which normally, but not always, refers to the seat of the board of directors; there are special rules of residency for companies formed in Canada before 26 April 1965.
However, the Income Tax Act uses the term "Canadian corporations" in a defined (and more narrow) manner: paragraph 89 (1) (a) of the Act reads as follows:
  89 (1) (a). *"Canadian corporation"*. - "Canadian corporation" at any time means a corporation that was resident in Canada at that time and was
  (i) incorporated in Canada, or
  (ii) resident in Canada throughout the period commencing June 18, 1971 and ending at that time....
For most purposes of Canadian tax law, the distinction between a defined "Canadian corporation" and a foreign corporation which is resident in Canada under the common law rule is of no effect. However, there are important exceptions; most "rollover" and tax-free reorganization rules such as section 85 (see note 4) require a "Canadian corporation" and not one merely resident in Canada. To avoid confusion herein, where the tax rule under discussion turns on the question of corporate residence, reference will be to a "Canadian resident company" with the use of "Canadian corporation" being restricted to those circumstances requiring a company whose status is in accordance with paragraph 89(1)(a).
6. Where a Canadian resident company distributes property to its shareholders, whether in liquidation or otherwise, it is required to recognize a gain as if it had sold the property at fair market value (subsection 69(5)). The only exception to this rule is a liquidation of a Canadian corporation into a parent Canadian corporation (or one which owns at least 90% of its shares) (subsection 88(1) of the Act).

Contents

The article will proceed by considering, in section II, underlying and basic factors, concepts and patterns of taxation relevant to and important in establishing the optimum structure for business start-ups and investments, generally, from the Canadian tax standpoint; section III will deal with some additional factors particular to passive foreign investment in Canada.

II. BASIC FACTORS AND PATTERNS OF CANADIAN TAXATION – INFLUENCE ON STRUCTURING STRATEGY

A. Tax on net income v. tax on gross income

1. Tax on net income – Part I of the Act

Although general rules abound, the Canadian tax system is sufficiently complex and its double tax agreement network sufficiently wide[7] to require close attention to the particular factors of each situation – type of investor, his country of residence and type of investment – and, usually, consideration to several alternative structures and forms of investment. However, the general scheme of the manner in which Canada taxes foreign investment results in one of two taxation patterns, regardless of the particular facts or structure selected:

- normal corporate or progressive individual tax rates[8] applied to net income or profit;[9] or
- flat (25%) withholding tax applied to gross revenue or gross receipts.

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7. Canada has 61 double tax agreements (tax treaties) in force or in some phase of negotiation or implementation, at the time of writing. Treaties have been signed and are in force with 32 countries, await ratification with 3 countries, have been initialled but not yet signed or published or are in negotiation with 26 other countries. In addition, 7 treaties in force at present are under renegotiation, to bring them in line with the 1977 OECD Model Convention, which serves as the basis for Canada's modern treaties. With certain exceptions, such modern treaties conform closely with the principles set out in the OECD Model. Two of the important pre-OECD Model treaties now in force are with the Netherlands and the United States, both offering tax planning opportunities, particularly in the area of real estate investment, not found in the modern or new generation treaties. The U.S.-Canada treaty has been renegotiated, and a new treaty was signed in 1980 and at time of writing awaits ratification. Renegotiation with the Netherlands is under way.

8. In this pattern, a foreign investor will be subject to the same type of tax rates applicable to a Canadian resident individual or corporation although modifications may arise where applicable to non-residents. For example, the normal aggregate Federal and provincial corporate tax rate is in the area of 50% but private Canadian corporations which are not controlled by non-residents ("Canadian-controlled private corporations", per paragraph 125(6)(a) of the Act, including situations where non-residents own up to but not more than 50% of the shares) may be entitled to a rate reduction of 21 percentage points in respect of Canadian business profits under section 125 of the Act (see also note 52). For individuals subject to a progressive rate scale, taking into account proposals of the 12 November 1981 Budget, maximum aggregate Federal and Provincial personal tax rates range from a low of roughly 47% in the Province of Alberta to roughly 61% in the Province of Québec. Foreign individuals subject to this first pattern of taxation may sometimes be liable only for Federal income taxes, in which case the aggregate rates (including a surtax in view of the absence of provincial taxation) would give rise to maximum rates of roughly 50%.
Unlike certain countries such as the United States, the Federal and provincial tax regimes are parallel and complementary in the sense that the Federal taxes are not deductible in computing the taxable income base for provincial purposes or vice versa, but rather the rates at the Federal and provincial levels are established in a fashion which take cognizance of the other. It can be noted that, at the time of writing (February 1982), the Federal and provincial authorities are experiencing difficulty in working out revenue sharing programs and it is not unlikely that provincial tax rates will increase, thereby increasing the aggregate Federal and provincial rates noted earlier. Prior to the 12 November 1981 Budget, aggregate personal tax rates ranged from roughly 59% in the Province of Alberta to nearly 70% in such provinces as Québec, and the present uncertainty from the Federal-provincial revenue sharing debate is whether the provincial governments will be forced to emasculate all or part of the cuts in personal tax proposed in the Federal Budget.

9. Net income or profit ("income" within the terminology of the Income Tax Act) means income determined in accordance with general accepted accounting principles unless modified by specific statutory or case law to the contrary. A more important aspect of such modification is the substitution of the Canadian "capital cost allowance" system for book depreciation. For a detailed review of these concepts, reference should be made to the papers by Harris and/or McQuillan.

(a) *Basic rule: Mainstream tax*

The first pattern of taxing regime arising under Part I of the Income Tax Act[10] applies to:

- business operations in Canada owned and carried on directly by investors, that is, not through a Canadian subsidiary;[11]
- certain gains realized directly by foreign investors in respect of certain types of Canadian property and which are not otherwise included in business profits;[12]
- investment income or business profit regardless of source or type earned through a Canadian resident (subsidiary) company;[13]
- rents derived from real estate the operation of which is not considered to comprise a business but in respect of which certain "net income" elections have been made.[14]

(b) *For corporations: Secondary taxes (branch v. subsidiary corporation)*

Where a company is involved, there may be a secondary tax.

(i) *Branch tax – Part XIV of the Act*

Under Part XIV of the Act, a non-resident company is subject to a "branch tax" on business income earned in Canada, whether or not involving a fixed place of business or permanent establishment within the treaty concept thereof. The rate of this tax is 25% and it applies to the excess of the income base determined for purposes of the mainstream corporate tax payable under Part I of the Act as described earlier, over the amount of such mainstream corporate taxes (including those levied by the provinces).

Generally, the rate of such tax is reduced by treaty, and the reduction normally is to the rate which would apply to dividends were the business carried out through a Canadian subsidiary. As in the case of mainstream corporate tax, where a treaty is involved, there is normally an exemption from the branch tax if the business profit earned in Canada is not effectively connected to a permanent establishment in Canada.

(ii) *Subsidiary: Dividend withholding tax – Part XIII of the Act*

Under Part XIII of the Act, where the foreign investor utilizes a Canadian resident company as a subsidiary to make the investment or carry on the business, profits realized by the subsidiary are subject to withholding tax when repatriated by way of dividend payments; the rate of withholding tax is 25%.[15] As a general rule, Canada's treaties do not reduce the withholding tax below 15%.[16]

The 12 November 1981 Budget proposes an important change to the dividend withholding tax rules. Under present law,[17] the rate of withholding tax otherwise exigible (whether or not the rate is subject to treaty reduction) is reduced by 5 percentage points where there is Canadian ownership of 25% or more of the Canadian resident company; accordingly, in a typical treaty situation where the withholding tax rate is normally 15%, there would be a one-third reduction to a net withholding rate of 10%.

The Budget proposes to eliminate the 5 percentage point reduction.[18]

(iii) *Branch–subsidiary comparison*

Nominally, the branch tax is payable in the year profit is earned, with the result that the use of a subsidiary can appear to be more advantageous as the secondary tax (on dividends) due in respect thereof can be deferred for as long as profits are maintained in Canada; however, comparable timing results as between a branch tax or a tax on dividends paid by a subsidiary often arise where regard is had to the deferral available in respect of the branch tax where profits are reinvested in the business carried on in Canada.[19] Also, under certain of Canada's treaties, branch tax may be subject to broader restriction or exemption in favour of the foreign investor than dividends paid by a subsidiary.[20]

2. Tax on gross income – Part XIII of the Act

The second pattern of regime, comprising a flat withholding tax of 25% on gross revenue or receipts derived from Canada, arising under Part XIII of the Act applies to:

- passive income such as interest, dividends, royalties or rents realized directly by a foreign investor and not effectively connected[21] to a business carried on in Canada;
- certain "deemed" income amounts arising out of transactions between foreign shareholders and Canadian resident companies; for example, certain loans by such companies to such shareholders.[22]

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10. The Income Tax Act consists of 258 sections divided into 16 parts, the most important of which is Part I comprising sections 1 through to 180, although for foreign investors Parts XIII and XIV (see below) are also of substantial application and import. Part XIII comprises sections 212 to 218 while Part XIV comprises section 219.
11. See, inter alia, paragraph 2(3)(b) and subparagraph 115(1)(a)(ii) of the Act.
12. See, inter alia, paragraph 2(3)(c) and subparagraph 115(1)(a)(iii) of the Act.
13. See, inter alia, paragraph 2(1) and (2) and Part I of the Act generally.
14. See, inter alia, section 216 of the Act, Section III below.
15. Subsection 212(2) of the Act.
16. Under Article X(2)(a) of the renegotiated but as yet unratified treaty between the United States and Canada, the withholding rate will be reduced to 10% in the case of corporate participations of 10% or more. Under Article VII of the Netherlands-Canada treaty, dividends paid by a Canadian resident company to a shareholder resident in the Netherlands stemming from non-Canadian source interest or dividend income, and where certain other requirements are met, are exempt from Canadian withholding tax. See also Article VII of the Canada-Ireland treaty.
17. Sections 212(3) and 257.
18. It is probable that the proposed rate reduction under the U.S. Treaty (see note 16) occasioned this proposal (see Resolution 154 of the Notice of Ways and Means Motion).
19. See section 219 of the Act.
20. Under Article X(6) of the Canada-Switzerland Treaty, there is a complete exemption from branch tax on business profits earned through a permanent establishment where the Swiss company's principal business is not carried out in Canada.
21. The term "effectively connected" is not used in the Act, rather the simple concept of income "from" a business or property.
22. Under subsection 15(2) of the Income Tax Act, certain loans made to shareholders are treated as income when not repaid by the end of the taxation year of the lending corporation following the year in which the loan is made. (It should be noted that the exemption where such loans are repaid does not apply if the loans are part of a series of loans or repayments. This rule also applies in the case of loans made to non-resident shareholders and the loan is treated as a dividend for purposes of the withholding rules noted earlier, pursuant to sections 212 and 214.

The tax is applied to gross revenue and, without benefit of deduction for expenses incurred by the foreign investor and in the case of rental income, may require that the gross revenue to which the tax applies be "grossed up" for payments required to be made by the tenant under the lease which normally constitute "owner" expenses.[23]

3. Structuring to achieve advantageous regime

(a) *Basic considerations*

There can be substantial differences in the net tax depending which of the two regimes applies; some situations are susceptible to "structuring" to achieve the optimum arrangements. The conceptual basis to "structure" or effectively select, as between the two regimes, is the underlying notion of whether or not the investment gives rise to a carrying on of business: if it amounts to a business, the Part I net income regime applies; if not, the Part XIII gross income regime applies.[24]

This dichotomy is similar to that of other tax systems such as that arising under the Internal Revenue Code of the United States.[25] Because there are no statutory rules for distinguishing between activities which amount to a carrying on of business and those which do not, the characterization is governed by somewhat flexible case-made law. This can give rise to uncertainties in marginal situations. Case law has generally involved issues respecting revenue-producing real estate in the context of domestic taxpayers where a similar distinction has been required for other purposes of the Canadian Income Tax Act.[26]

In principle, the distinction will turn on the degree of continuous entrepreneurial or managerial activity required to be exercised in earning the income from the investment. For example, in the case of the rental of property, particularly where the owner-lessor is not required to provide substantial services, it may be difficult to achieve taxation under the Part I net income regime, and a foreign lessor may well pay a greater tax under the Part XIII regime. However, in the case of rental real estate, foreign investors, otherwise subject to the Part XIII regime are entitled to elect to be taxed on a net income basis.[27] It will be noted below, under the section dealing with the role of a trust, that foreign investors can sometimes achieve net income taxation on purely passive payments by structuring a trust resident in Canada to make the investment.[28]

The general principle governing the distinction may well be subservient to a second principle, evolved in case law, that a corporation is presumed to be formed for the purpose of carrying on business with the result that what may give rise to passive income (from "property") in the hands of an individual may be considered to be derived from the carrying on of business in the hands of a corporation, particularly where it has no other activities.[29]

(b) *Withholding tax issues*

Finally, it should be noted that in unclear situations, the direct foreign investor may be subject to withholding tax at source, refundable to the extent that it subsequently can be successfully asserted that the income upon which withholding was levied was effectively connected to a Canadian business (and thus to be taxed in accordance with the Part I net income regime). The payor of an amount contemplated by Part XIII, such as dividends, interests, rents, royalties, to a non-resident is required to withhold the statutory Part XIII 25% tax regardless of whether the amount is earned by the resident in the course of carrying on business in Canada, unless the non-resident has obtained a certificate from the Minister of National Revenue evidencing that the payment is exempt from withholding tax on the basis of being connected to a Canadian business. The Minister is only required to issue this certificate where he is of the opinion that the payment is indeed related to carrying on a business.[30] Refusal of the certificate does not, in and of itself, establish the basis upon which the income is to be taxed, merely that the payor is required to withhold Part XIII tax and leaving it open to the non-resident investor to make a claim for refund of the tax under Part XIII[31] and file returns of income on the net basis under Part I of the Income Tax Act.

B. Joint investments: Partnership v. co-ownership

1. Basic considerations

Foreign investors also face choices with respect to appropriate structure for joint investments:

- whether to proceed in unincorporated form and to be taxed as a partnership or as a mere co-owner;[32]
- whether to incorporate, with the "joint" element being reflected simply by shareholdings.[33]

Although a partnership is not a separate person[34] for Canadian tax purposes (but, rather, usually serves as simply a tax accounting center with each partner thereof accounting for his share of partnership activities, profits, etc. as though a sole proprietor in respect thereof[35]), there can be important differences between the applicable rules so as to warrant an assessment of the feasibility of selecting or structuring for one mode rather than the other.

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23. *Burland* v. *M.N.R.* 68 D.T.C. 5220.
24. Of course, as already noted net income taxation can always be achieved by utilizing a Canadian resident company to make the investment regardless of whether its activities amount to a carrying on of business. Also see section III. B. below dealing with the use of a Canadian resident trust.
25. Sections 861, 864, 871, 881 and 882 of the Internal Revenue Code, 1954 as amended.
26. See *Wertman* v. *M.N.R.* 62 D.T.C. 1020; *Walsh and Micay* v. *M.N.R.* 64 D.T.C. 2032.
27. Section 216 of the Act.
28. See note 24.
29. See, for example, *Birmount Holdings* v. *The Queen* 77 D.T.C. 5031, but also see the (contrary) views of Revenue Canada: paragraph 10 of Interpretation Bulletin IT-420R2.
30. Subsection 214(13) of the Act and section 805 of the Income Tax Regulations, which were amended in 1981 to include certain payments in respect of resource property.
31. Subsection 227(6) of the Act.
32. The Canadian tax system does not distinguish between a co-owner or joint venture or member of a syndicate, all such direct undivided interests (which are not considered to comprise a partnership) being treated as though the investor were a sole owner or proprietor in respect of his undivided interest in the property and related revenues, costs and expenses.
33. The possibilities of a third format – trust – are dealt with below.
34. Taxpayers under Canadian tax law are "persons" which include individuals, corporations or estates or trusts, but not partnerships.
35. Subsection 96(1) of the Act.

Generally, investors prefer to be treated as mere co-owners in order to have optimum flexibility in determining write-offs and deductions. These and other differences between partnerships and co-ownerships are reviewed in the third section below.

2. Structuring for the desired mode

In theory, it is always possible for joint investors to arrange either partnership or mere co-ownership, although in practice it is not feasible for certain types of joint investments to avoid characterization as a partnership. This is because (and unlike the United States, for example) the taxation law does not contain special or additional rules for characterizing a joint investment, leaving the determination to be made under the relevant property or contract law applicable.[36]

Joint investors can generally "structure" mere co-ownership by incorporating the following features in their arrangement:

- avoid formal declaration of partnership;
- avoid joint and several liability – both as between them and in their relationship with third parties;
- maintain investor interests in revenues, costs and expenditures in proportion to the interest in the underlying property;
- maintain the right to a direct interest in the gross proceeds or receipts;
- avoid having one co-owner act as general agent or mandatory, with a general power to contract, on behalf of the other co-owners.

Because the determination is left to commercial law, this means, in Canada, reference is made to provincial law of property or contract dealing with partnerships. The views of the Department of National Revenue, reflective of these principles, are set forth in Interpretation Bulletin No. IT-90 which outlines the issue succinctly as follows:[37]

> 1. The Income Tax Act does not define a "partnership", but outlines the tax consequences if one exists. Section 102 defines what is meant by a "Canadian partnership", but presupposes that there is a partnership. A partnership is not a person, nor is it deemed to be within the meaning of the Act, notwithstanding that section 96 provides that the income of a member of a partnership is computed as if the partnership were a separate person resident in Canada.
>
> 2. Generally speaking, a partnership is the relation that subsists between persons carrying on business in common with a view to profit. However, co-ownership of one or more properties not associated with a business (which under Common Law might be a joint tenancy or a tenancy in common) does not of itself create a partnership, and this is so regardless of an arrangement to share profits and losses. For guidance on whether a particular arrangement at a particular time constitutes a partnership, reference should be made to the relevant provincial law on the subject and such law will be viewed as persuasive by the Department of National Revenue.
>
> 3. A characteristic of a partnership is a sharing of profits of a business as opposed to a sharing of gross returns. Where the share of profits represents the payment of an obligation as opposed to a partnership right to so share, any presumption of partnership relating to the share of profits is rebutted.
>
> 4. A joint venture agreement, whereby two or more persons agree that each provides his own property to perform a specific task and receives a specific division of profits from such a task, may be considered a partnership as regards such profits; but as long as the property is not held under joint tenancy or tenancy in common, it is not considered to be partnership property. Thus the capital cost allowance provision relating to partnership property does not apply.
>
> 5. Where several persons form an association for the purpose of carrying out particular business transactions in which they are mutually interested, the association has the characteristic of partnership. However, such persons may associate without each accepting total liability for the association's debts. In these circumstances, contracts may indicate that the associated persons will be liable only for their respective agreed portions of the debts. The existence of such an arrangement is viewed as an indication that a partnership does not exist. One of the original examples of this type of association which does not constitute a partnership is a syndicate of insurance underwriters. Associations or syndicates in connection with natural resource industries often are in the same category.
>
> 6. Since a partnership is a relationship between persons carrying on business for profit, the type and extent of a person's involvement in the business is relevant in determining whether he is in reality a partner . . .

3. Differences in taxation of partnership and co-ownership

It was noted earlier that partners account personally for their shares of partnership activities, profits and losses, etc. and to that extent partnership income is taxed in Canada on a basis comparable to that earned by a mere co-owner. However, important differences between the two types of arrangement can arise and are as follows.

(a) *Timing of income*

A co-owner has more flexibility than a partner in determining the timing of claiming deductions in computing net income for Part I purposes where there is a discretionary element thereof. This is because in the case of partnership, it (the partnership) is required to compute income, and make appropriate deductions, with a partner accounting for his share thereof. Therefore each partner is subject to the will of the majority of the

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36. In contrast, see sections 761 and 7701 of the Internal Revenue Code. It should be noted that also unlike the United States, in Canada an association of investors is never treated as a corporation unless actually carried out through a company formally incorporated under applicable company law: cf. section 7701, Internal Revenue Code.

37. See also: "The Business of Defining a Partnership under the Income Tax Act", Howard Kellough, *Canadian Tax Journal*, XXII (2), March-April 1974, p. 190.

partners as to the manner in which such elections are made.[38]

For example, the system for deduction of depreciation, in the form of a capital cost allowance, on capital assets provides taxpayers with a great deal of flexibility in timing deductions inasmuch as the amount of such claim in a particular year is at the discretion of the taxpayer, subject to the maximum limits thereof.[39]

This can be of particular importance in the case of a foreign investor for the reason that if there is a net loss from the partnership business, the benefits thereof can only be carried forward and enjoyed during the subsequent 5 taxation years.[40]

To the extent that losses arise as the result of the manner in which timing options and elections have been exercised, the foreign investor, as partner, faces the possibility of losing the benefit thereof if the losses cannot be used in the 5-year carry forward period; in contrast, a co-owner would have been entitled to select a tax-accounting rule, in the initial year, that would have avoided the creation of losses which subsequently become stale-dated. The problem can be particularly acute where the foreign investor is in a joint investment with a Canadian person who may often be in the position to immediately enjoy the benefits of losses from the partnership, as an offset against other sources of income subject to Canadian tax,[41] whereas the foreign investor without other Canadian business activities would not enjoy such an advantage.

Conversely, if all of the joint investors are foreign persons, it is likely that their interest will be common and the agreed timing of recognizing income through partnership elections and options will not prejudice any particular partner.[42]

(b) *Partnership interests – Co-ownership interests*

Although a partnership is not a separate person for Canadian tax purposes, an interest in the partnership is recognized as a separate property and transactions in or in respect of such interests can give rise to Canadian tax effects – whereas a mere co-owner simply has a direct "undivided" interest in each property (comprised of the co-ownership) for Canadian tax purposes. Normally, a partnership interest is treated as a capital property with the result that a disposition thereof normally gives rise to capital gain taxation, whereas disposition of an interest in a co-ownership requires identification of the nature of each property disposed of and may give rise either to capital gain or ordinary income, the latter, for example, in respect of the disposition of inventories of the co-ownership or recapture of capital cost allowance previously claimed; the notions of capital gains and recapture of capital cost allowance merit further consideration.

(i) *Capital gains*

First, under Canadian tax law, the general rule is that where a property used to produce or gain income is disposed of, a capital gain arises, measured as the excess of the proceeds over the "adjusted cost base"; one-half of such "capital gain" is a "taxable capital gain" required to be included in income to be taxed at ordinary rates.[43] Where a foreign investor is involved, such taxation will arise (see above respecting the first pattern of taxation) if the property is considered to be a "taxable Canadian property".[44] Such property includes, inter alia, Canadian real estate, shares of private Canadian corporations,[45] movable or personal capital property used by a foreign investor in carrying on business in Canada or interests in partnerships 50% or more of the property of which comprises the type of property just noted.

The implications thereof are twofold. On the one hand, it is possible that a foreign investor's interest in a Canadian business partnership will not be subject to Canadian tax upon a disposition where, for example, the majority of assets of the partnership does not comprise taxable Canadian property. On the other hand, if the latter is not the case and the partnership interest is a "taxable Canadian property", the disposition thereof will generally give rise to capital gains, not ordinary income, notwithstanding that a sale of the underlying property would give rise to ordinary income. It should be noted, however, that the purchaser of the partnership interest does not achieve a step-up in cost base in respect of his interest in the underlying properties of the partnership for purposes of future computation of profit or loss from the operations of the partnership.[46]

The terms of a Canadian treaty can give rise to additional differences between the tax arising on the disposition of an interest by foreign investor as partner rather than as co-owner. Most new generation, OECD model-based treaties would allow Canada to tax a foreign investor disposing of a direct interest in properties owned in co-ownership and used in carrying on business in Canada.[47] However, these treaties normally provide exemption from Canadian taxation in respect of gains realized in

38. The only exception to this rule is in respect of certain exploration and development of costs in respect of resource ventures (subsection 96(1) of the Act).
39. See Part XI of the Income Tax Regulations: cf. the rule in the United States where minimum depreciation is deemed to be claimed.
40. Section 111 of the Act.
41. As a general rule, a Canadian resident taxpayer may offset losses from one source of business or investment against income from other sources, whether earned directly or through a partnership (paragraph 3(d) and section 96 of the Act).
42. Timing options can arise with respect to both the recognition of gross revenue or claiming deductions or expenses. Subject to important modifications proposed in the 12 November 1981 budget (see also the 18 December modifications thereof), taxpayers can normally, for example, claim reserves in respect of instalment sales. Timing options, arise, inter alia, in respect of the immediate deductibility of interest expense (under paragraph 20(1)(c)) or the capitalization thereof (under section 21), depreciation on tangible capital expenditures and on some forms of limited life intangibles (under section 20(1)(a) and Part XI of the Income Tax Regulations) and the deductibility of certain intangibles such as goodwill (collectively: "eligible capital expenditures") (under paragraph 20(1)(b) and related provisions of section 14 of the Act).
43. Sections 3 and 38-55, I.T.A.
44. Taxable Canadian property is defined in paragraph 115(1)(b), I.T.A.
45. Paragraph 89(1)(f) of the Act: that is, a corporation the shares of which are not treated on a stock exchange in Canada nor controlled by such a company.
46. Again, this is in contrast to the U.S. system (see section 754 of the Internal Revenue Code).
47. See, typically, Article 13(2) of Canada's newer treaties and the same article in the 1977 OECD Model Convention.

disposing of an interest in a partnership unless the principal property thereof comprises immovables.[48]

(ii) *Recapture of capital cost allowance*

Any recovery (recapture) of capital cost allowance previously claimed upon the disposition of the subject depreciable property is required to be included in ordinary income and only proceeds realized in excess of original cost are subject to capital gains treatment.[49]

However, where an interest in such property is disposed of through the sale of a partnership interest, the general rule holds and the recapture realized in the form of a gain on the disposition of the interest is accounted for as capital gain; however, as already noted, the purchaser of such an interest would not enjoy a step-up in cost base in the underlying property.

(c) *Transactions between partner and partnership*

Another important difference between partnerships and co-ownerships to be noted and considered in structuring the joint investment is the general rule that transactions between a partner and a partnership are considered to take place at fair market value and that, for example, where a partnership property is transferred to a partner, a taxable gain may arise. The exceptions to the rule, providing for "rollovers", are restricted to transactions involving "Canadian partnerships" requiring that all partners be residents of Canada.[50] In contrast, there is no recognition of any transaction between an investor and the co-ownership, unless it entails a disposition of property by one co-owner to another. However, an important exception to the general rule is that the cash withdrawals by a partner, if and when in excess of his adjusted cost base, are tax-deferred.

4. Joint ventures through a "Canadian-controlled private corporation"

It was noted earlier[51] that private Canadian corporations may be entitled to a corporate tax rate reduction of 21 percentage points[52] where not more than 50% of their shares are owned by non-residents. This reduction, applicable to the first $200,000 of net income in a year, and subject to an overall limit of $1,000,000 (under the 1981 Budget proposals), can make it advantageous to carry out joint investments with Canadian partners through a single corporation, rather than by way of co-ownership or direct partnership.

C. Financing and licensing factors

1. General considerations

The combined effect of Part XIII taxes (25% flat withholding on gross payments) on dividends, interest, royalties and rents paid to foreign investors and deductibility of certain of such payments under Part I of the Income Tax Act can provide several options in structuring Canadian investment and business undertakings. Subject to the thin capitalization rules (below), equity provided in the form of debt can produce interest charges deductible against high taxed income, substituting therefor lower Part XIII withholding taxes. In contrast, equity provided either directly by the investor or by share investment in the company utilized to make the investment or undertake the business produces non-deductible dividend payments. Similarly, the licensing of technology rather than outright transfer or direct use thereof can produce different tax results. The range of the possible results, assuming one of Canada's newer treaties in respect to a business venture, may be seen in the following comparisons:

	Financing		Technology	
	Debt	Equity	Licensing royalty	No royalty
Profit	$100	$100	$100	$100
Interest or royalty charge	(100)	–	(100)	–
Taxable profit	–	100	–	(100)
Corporate profit tax (Part I) @ 50% (a)	–	$ 50	–	$ 50
Secondary – branch (Part XIV) or dividend (Part XIII) tax and Article X(2) @ 15% (b)	–	$ 7.50	–	$ 7.50
Part XIII and AXI (3) @ 15% (c)	$ 15	–	–	–
Part XIII and AXII (4) @ 10% (d)	–	–	$ 10	–
Net return	$ 85	$ 42.50	$ 90	$ 42.50

(a) Actual combined federal and provincial taxes may range from 25.5% to 51% depending upon applicability of a 6 percentage point reduction for manufacturing and processing operations or (section 125.1 I.T.A.) and the particular province involved (where tax rates may range from a low of 5.5% in the Province of Québec (in 1983 and subsequent years) to a high of 16% in British Columbia, and leaving aside a temporary 5% federal surtax (section 124.2 I.T.A.) which is to be extended through 1983 under the 12 November 1981 Budget. See notes 8 and 52 and related texts.

(b) See, for example, treaties with Switzerland, U.K., France, Germany (as yet unratified), Belgium and Italy.

(c) See treaties referred to in (b).

(d) See treaties referred to in (b).

2. Debt v. equity: Thin capitalization and withholding taxes

The general rule providing deductibility, under Part I, for financing charges is subject to thin capitalization restrictions where paid by a Canadian resident company to certain foreign shareholders or persons affiliated with them. In order for full interest charges to be deductible, the ratio between loans provided by such foreign shareholders owning 25% or more of the shares of the Canadian resident operating company and the balance sheet equity thereof must not exceed 3:1. Persons not dealing

48. See, for example, Article XIII(4) of the Canada-Switzerland income tax treaty.

49. Section 13, I.T.A.: this may be contrasted to the rule in the U.S. in respect of certain straight-line methods of depreciation of real property where recaptured depreciation is treated as a capital gain (see the Economic Recovery Tax Act).

50. See sections 97, 98 and 102 of the Act.

51. See note 8.

52. Where regard is had to the 6 percentage point reduction in corporate tax rates (5% where the 21% reduction applies) in respect of manufacturing profits under section 125.1 of the Act and recent corporate rate reductions in the province of Québec, overall corporate rates may be as low as 13%.

at arm's length[53] with shareholders are taken into account for this computation as well as back-to-back loans made through foreign banks or other financial intermediaries.

Interest paid or incurred in respect of debt in excess of the 3:1 ratio is not deductible in computing taxable income under Part I of the Act. This means that in establishing a Canadian subsidiary with, for example, a $1,000,000 investment at least $250,000 must be invested by way of share capital in order that interest charges on the balance be deductible.[54] However, these rules do not apply to operations carried on in Canada through a branch of a non-resident Canadian company.[55]

Canadian withholding taxes under Part XIII in respect of such financing charges are exigible at the rate of 25% unless reduced by treaty which, as noted above, normally provides for reduction to 15%. There is also provision under the domestic law for exemptions from withholding tax on interest paid to arm's length persons on loans made before 1983 where no more than 25% of the principal amount of the loan is required to be repaid, in the absence of default, during the first 5 years of the loan.[56]

It is not known at the time of writing whether this exemption, introduced in 1976, will be extended, as it had been from the initial expiry date of 1979. Considering that arm's length relationship arises where the share ownership is restricted to 50% or less or that back-to-back loan arrangements are not specifically ruled out (as in the case of the thin capitalization rules), there is some degree of flexibility in some circumstances to take advantage of this exemption in financing business start-ups in Canada – although concerns respecting agency or sham and the imminent expiry of the exemption reduce substantially the potential interest therein.[57]

3. Transfer of technology

The basic question may arise as to whether to license or assign (outright) industrial technology (patents and other proprietary rights or non-exclusive or non-proprietary technology, such as know-how). The parameters are as follows.

From the standpoint of deductibility to the operating entity (say Canadian subsidiary), royalties or similar payments are normally deductible in the year in respect of which the payment arises while the cost of an outright acquisition is either deductible over the life of the technology in the case of limited life rights or at the rate of 10% but only on one-half of the cost of unlimited life rights, unless the benefits obtained are of current or short-lived duration in which case the entire cost may be deductible in the year in which acquired.[58]

From the standpoint of taxation to the foreign transferor or licensor, Canadian tax could arise under either Part I of the Act or Part XIII, as more fully discussed in the next paragraphs.

Normally, the transferor will not be subject to tax under Part I, on the net income basis, in respect of either a single transaction of transfer of his technology or licensing thereof to a Canadian business enterprise, whether in the form of outright transfer or technology license. This is because either the transaction does not amount to carrying on of business in Canada,[59] or, even if it does, exemption, in the case of outright transfers, should arise under the normal business profits rule of a Canadian treaty.[60]

Uncertainty can arise in respect to the outright assignment of some but not all of a transferor's proprietary interests in his technology, such as in the case of the provision of know-how. The issue will be whether or not a mere "use" is being provided; but, notwithstanding some uncertainty in the jurisprudence, it would seem that in the absence of any restriction on the use to which the technology may be put, withholding taxes under Part XIII should not arise.[61]

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53. Non-arm's length relationships exist where there are certain defined relationships between persons such as a common parent or where a person controls a corporation or persons are affiliated by blood or marriage relationships (paragraph 251(1)(a) and subsection 251(2) of the Act or, in the absence of such relationships as a matter of fact, entailing the question of separate economic interests or a common directing mind whithin rules made under case law and pursuant to paragraph 251(1)(b)).

54. The 1981 Budget would exclude third-party shares, if any, from "equity".

55. Canada's treaties do not restrict the applicability of Canada's thin capitalization rules and, for example, the renegotiated treaty between the U.S. and Canada specifically precludes a claim under a non-discrimination clause (Article XXV(8)):

> 8. The provisions of paragraph 7 shall not affect the operation of any provision of the taxation laws of a Contracting State:
>
> (a) Relating to the deductibility of interest and which is in force on the date of signature of this Convention (including any subsequent modification of such provisions that do not change the general nature thereof)....

56. Subparagraph 212(1)(b)(vii) of the Act.

57. With respect to the concerns respecting sham or agency it should be noted, however, that for purposes of both the section 212(1)(b)(vii) exemption and the section 18(4) thin capitalization rules, a bona fide third-party loan simply collaterized or secured or guaranteed by a foreign shareholder would be perfectly acceptable. With respect to the concern respecting sham or agency in respect to back-to-back loan arrangements designed to circumvent the arm's length requirements of section 212(1)(b)(vii), see the decision of the Supreme Court in *Swiss Bank Corp.* v. *Her Majesty the Queen* 72 D.T.C. 6470.

58. As a general rule, case law distinguishes between a current expenditure for purposes of gaining or producing income, pursuant to paragraph 18(1)(a) of the Act, and a capital expenditure entailing one which provides an enduring benefit to the acquirer or increases or augments the income earning process pursuant to paragraph 18(1)(b); in the latter case, specific provision for deductibility must be found within the rules of the Act or the Regulations. Where an intangible capital expenditure with a limited life is involved, Part XI and Schedules 2 and 4 of the Income Tax Regulations (made pursuant to and for the purposes of paragraph 20(1)(a) of the Act) provide for straight line write-off over the useful life of the right acquired while section 14 of the Act provides for a 50% deductibility, at the rate of 10% per annum on a declining balance basis, in respect of intangible capital expenditures without a limited life, within the "eligible capital property" rule referred to above (note 42).

59. Section 253 of the Income Tax Act extends the meaning of carrying on business in Canada to include a mere offering for sale of anything in Canada. On the other hand, a single isolated transaction ("adventure in the nature of trade") has been held not to amount to the carrying on of business (*Tara Exploration Ltd.* v. *Her Majesty the Queen* 72 D.T.C. 6288).

60. The exemption would normally arise under Article VII of the OECD based treaties unless the payments in respect of the outright transfer are contingent in nature and thus perhaps are contemplated by the royalty provisions normally found in Article XII of such treaties.

61. Paragraph 212(1)(d) of the Income Tax Act provides for 25% withholding tax on rents, royalties and similar payments including, inter alia, any type of payment for the right to use in Canada know-how or other non-proprietary technology. In *St. John Shipbuilding Dry Dock Ltd.* v. *Her Majesty the Queen* 80 D.T.C. 6272, the Federal Court of Appeal suggested that lump sum payment for sale of a computer program to build ships would have been subject to withholding tax under the rent or royalty rule had it not been for exemption arising under provisions under the current treaty between the U.S. and Canada. However, it seems that restrictions placed on the right of the Canadian acquirer to alienate and the requirement to maintain confidentiality brought the

Where the technology transfer arrangement involves the payment of either a conventional royalty or licensing fee or a lump sum price, the payment of which is contingent upon the use (sales, profits, etc.) of the transferee or licensee, the Part XIII, 25% withholding tax will apply.[62] Canada's newer treaties do not eliminate the liability but restrict the rate to 10%.[63]

4. Intercompany pricing considerations

As a general rule, intercompany pricing arrangements, including those respecting the provision of financing and technology, must conform to a fair pricing or reasonable price standard, in the absence of which deductibility for Part I purposes may be denied to the payor and Part XIII 25% withholding tax (to the extent not otherwise applicable) on disguised or deemed corporate distributions may arise for the payee in respect of an excess price. It is to be noted that the Canadian rules in this area are comprised largely of broadly stated principles[64] without elaborate statutory language or a substantial body of case law.

D. Anticipating the ultimate disposition

Structuring the investment or business start-up from the standpoint of minimizing Canadian taxes on an ultimate disposition turns on three basic factors:

- under the Income Tax Act, as already noted, gains realized on the sale of "taxable Canadian property" comprising, inter alia, shares of private Canadian resident companies, Canadian real estate, resource properties or capital properties used in carrying on a directly-held business[65] or other property thereof[66] are subject to tax;
- Canada's new generation treaties would generally exempt the sale of shares of private Canadian companies whose principal property does not comprise real estate;[67] and
- the sale of shares of a foreign company (a non-Canadian resident company) is not subject to tax under the Income Tax Act; but, on the other hand, a purchaser of the shares thereof cannot achieve a step-up in cost base for Canadian tax purposes in respect of the property owned by such corporation without undertaking a liquidation which would give rise to immediate taxation, in respect of the type of Canadian properties noted above.[68]

It was just noted that the purchaser of shares of a foreign company used to carry on a Canadian business does not achieve a step-up in cost base in the underlying properties on a tax-free basis, thus decreasing the potential benefits of a sale of the shares of such a company without liability to Canadian tax. However, the results are not much different in respect of a sale of the shares of a private Canadian company which, absent a treaty exemption, would be subject to Canadian tax. In particular, and unlike the rules, for example, in the United States,[69] a purchaser of the shares of a Canadian corporation may only achieve a step-up in cost base in respect of non-depreciable capital property (thereby excluding inventories and depreciable properties, such as plant and equipment or intangible assets such as goodwill, etc.) by acquiring the shares through a Canadian holding company and proceeding with the liquidation of the acquired company into such holding company.[70]

Accordingly, where the choice is between a Canadian resident company and one which is not resident, from the standpoint of ultimate disposition, the use of a foreign corporation will be preferable in the sense that reliance upon treaty exemption is not required. Finally, in this context Canada's treaties do not generally exempt a foreign direct investor from the sale of business properties or assets comprising a permanent establishment.

Individual foreign investors would also benefit from the insulation from Canadian tax, afforded by the holding of the shares of a non-resident company, arising under Canada's deemed disposition rules at death.[71]

III. ADDITIONAL FACTORS PARTICULAR TO PASSIVE INVESTORS

A. The role of the non-resident-owned investment corporation

Foreign investors in Canadian portfolio securities generally are exempt from Canadian tax in respect of dispositions thereof[72] and are subject to 25% withholding tax on

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payment within the concept of a mere use (as opposed to an acquisition of outright ownership) within the meaning of subparagraph 212(1)(d)(i), thus leaving it open to structure arrangements not comtemplated by that provision. It is also to be noted that subparagraph 212(1)(d)(i) refers to a use in Canada and not, in concept, a lump sum payment for a right of use which is not restricted to Canada.

62. Section 212(1)(d) of the Act.

63. See, for example, Article XII of the treaties with Switzerland, France, the U.K., Italy, Belgium and Germany.

64. Subsection 69(1) requires a fair market value price with respect to the sale of goods between related or non-arm's length parties; however, subsections 69(2) and (3) deal specifically with international non-arm's length transactions and refer to "reasonable price in the circumstances" and there is no jurisprudence to date on whether there is a difference between the two concepts. For detailed discussions of the various factors noted in this section, see "Intercompany Pricing: In Search of Guidelines", by George Tamaki and Richard Pound, *Canadian Tax Journal,* XXII (5), September-October 1974, p. 460; "Working with Canada's Technology Transfer Rules", by Nathan Boidman, *Tax Planning International Journal,* August 1981, p. 3; "Intercompany Charges for Services and Use of Property – Canadian Income Tax Considerations", a paper presented to the Canadian Tax Foundation Annual Conference in Toronto in 1974, by André Gauthier and written by Gauthier and Nathan Boidman and appearing in the 1974 Conference Report at page 145.

65. Subparagraph 115(1)(a)(iii) and paragraph 115(1)(b) of the Act, note 43 above and related text.

66. Subparagraphs 115(1)(a)(ii).

67. E.g. Article XIII(4), Switzerland-Canada Treaty.

68. Subsection 69(5) of the Act.

69. Sections 332, 334(b) and 336 of the Internal Revenue Code.

70. See subsection 88(1) I.T.A.

71. See note 1: capital gains exemptions provided in Canada's newer treaties in respect of shares of private Canadian companies (not principally involved in real estate activities) apply to deemed dispositions at death. The contrary was suggested by the Federal Court, Trial Division in the case of *Davis* v. *The Queen* 76 D.T.C. 6109, in an obiter dictum respecting the exemptive provisions of Article VIII of the current U.S.-Canada Treaty in respect of a "sale or exchange" but the wider ambit inherent in the new generation treaty concept of "alienation" should make those comments of the Court, if correct, inapplicable.

72. A less than 25% holding in the shares of a public corporation that is, one whose shares are listed on a stock exchange in Canada (paragraph 89(1)(g) of the Act) and debt instruments of Canadian companies are excluded from the "taxable Canadian property" category and, in the absence of systematic and continuous trading activities in such securities in Canada, gains in respect thereof are not subject to Canadian tax.

interest or dividend payments, subject to treaty protection.[73]

However, gains and income in respect of such portfolio investments may be subject to full Canadian corporate taxation if held through a foreign corporation portfolio which is managed on a discretionary basis by a Canadian broker or other advisory personnel.[74]

To guard against this type of concern, a non-resident can structure Canadian portfolio investments, or other types of passive activities, through a company formed in Canada and qualified for purposes of the Income Tax Act as a "non-resident-owned investment corporation" which is taxed on a "flow-through" type basis. The chief characteristics of such a corporation are:

- all shares are owned by non-residents of Canada;
- investment and other undertakings are primarily of the passive variety, in compliance with specific statutory rules and, for example, no more than 10% of the income of the corporation can be derived from rents or royalties;
- the corporation has made an election to be taxed as a "non-resident-owned investment" corporation within 90 days after its formation or start of business.[75]

The scheme of the rules governing an NRO is to provide a foreign investor with the same overall Canadian taxes on distributed income and profits of the corporation as though the underlying investments had been held directly. The principal rules and the procedures to achieve this result are:

- dividends, interest and other incomes are subject to an initial 25% tax in the hands of the corporation, which is totally refundable upon payment of dividends to shareholders;
- gains realized in respect of portfolio investments which if realized directly by the foreign investor (that is, shares of public corporations[76] and other non-"taxable Canadian property") are not subject to taxes at the level of the corporation.
- on payment of dividends, the NRO receives a refund of the initial 25% tax and Canadian withholding taxes on such dividend do not apply to the portion thereof stemming from capital gains which would be tax-free if realized directly.

There are, however, certain anomalies and difficulties in respect of:

- foreign investments by the NRO, and ideally the NRO is not used for non-Canadian investment purposes;
- investments in Canadian securities which if received directly would benefit from a reduction in or exemption from the standard 25%, Part XIII tax, such as corporate debt or bonds qualifying for the "5-year" exemption referred to earlier.[77]

An important manifestation of the last problem noted has been the loss of the 5 percentage point reduction in the rate of withholding tax on dividends paid by Canadian companies in which there is a 25% or greater Canadian ownership.[78] However, as noted earlier, the 12 November 1981 budget proposal to abolish this reduction will eliminate this particular adversity of utilizing an NRO to hold Canadian portfolio equities.

B. Role of Canadian resident trusts

A Canadian resident trust can serve to reduce taxation on Canadian source rents derived from personal or moveable property or royalty-type payments when such income is derived from investment activities which are not considered to amount to carrying on of business.[79] The trust provides a basis to achieve taxation under Part I[80] rather than under Part XIII,[81] and where tax under the former regime is less than that which would arise under the latter this approach is advantageous.

As already noted, a foreign investment which does not amount to the carrying on of business can be rendered subject to net income taxation by the use of a Canadian resident corporation. However, this entails not only the cost and complexities of a corporation but aggregate Canadian taxes (where regard is had to both the primary (mainstream) corporate taxes and the secondary distribution withholding taxes) of rates ranging up to 60% and greater.[82] A corporate structure may also prevent the investor from realizing optimum tax results in his country of residence; for example, it may preclude a flow-through of tax write-offs. It was noted in the preceding section that an NRO cannot be used to earn rents and royalties.

A trust can optimize results in both Canada and the State of residence by not only effecting net income taxation in Canada but, as well, a reduction of the overall Canadian taxes to a maximum of 25% of net income while possibly providing flow-through characteristics in the country of residence.[83]

The requirements of, and general considerations related to, effective trust arrangement in respect of passive rentals and royalties may be summarized in respect of a hypothetical situation where a helicopter having a cost of $100,000, financed at 20% per annum, is leased to a Canadian user at an annual rent of $30,000:

- if the helicopter is leased directly by the foreign investor(s) to the Canadian user, annual Canadian in-

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73. Part XIII of the Act.
74. As noted (note 5 above), a foreign company can be considered resident in Canada on the basis of central mind and management which, although generally is a reference to the seat of the Board of Directors, could also be determinated on the basis of day-to-day operational management; see the decision in *Crossley Carpet* v. *M.N.R.* 69 D.T.C. 5015.
75. Sections 133 and 134 of the Income Tax Act.
76. See note 72.
77. See note 56 and related text.
78. See note 17 and related text.
79. See note 24 and related text.
80. See section II(A)(1) above.
81. See section II(a)(2) above.
82. See note 80. It should also be noted that the 1981 Budget increases taxes on investment income earned through a Canadian resident corporation by eliminating the applicability of the refundable tax provisions of section 129 to foreign controlled corporations.
83. For example, typical commercial trusts may often be ignored for U.S. tax purposes allowing the U.S. inventor, as beneficiary or unit holder, to direct write-offs of the costs and expenditures of the trust. This may either arise under the grantor trust rules or as a matter of the trust being characterized as a partnership.

come taxes would arise at 25%, producing taxes of $7,500;[84]

- if a proper trust is constituted[85] and the trustee is a resident of Canada, the trust can acquire and lease the helicopter and be governed by the net income regime of Part I;[86]
- the trust could, for example, in its first year have no taxable income, the gross lease payments of $30,000 being offset by interest financing costs of $20,000 and depreciation claims of $10,000;[87]
- in a subsequent year when the gross lease payments exceed the aggregate financing and depreciation charges, the net income would either be taxed in the hands of the trust at the rate of roughly 50%[88] or in the hands of its beneficiaries at a maximum rate of 25%. Taxation in the hands of the trust would arise if the trust arrangements do not require that annual income be distributed to beneficiaries and in fact there are no such distributions in the year earned. Where such distribution is required and/or is made no tax arises under Part I in the hands of the trust, but rather a 25% withholding tax on the beneficiary under Part XIII.[89] If it is assumed that in the subsequent year in question aggregate financing and depreciation charges amount to $20,000, net income for Part I would amount to $10,000 and, in cases where the income is accumulating, Canadian taxes of $5,000, computed at the rate of roughly 50%, would be incurred, which may be contrasted to the gross withholding taxes of $7,500 which would arise where the helicopter is leased directly by the foreign investor; and where the income is payable to the beneficiaries, Canadian taxes would amount to $2,500 comprising the 25% withholding tax on the net income distributed to the beneficiary, comparing rather favourably with the gross taxes in the case of the direct holding;
- it is important to note that if the trust is not resident in Canada (that is where the trustee is a non-resident) the taxpayer would simply be a direct foreign investor, bringing into effect the flat withholding tax of 25% on gross lease payments under Part XIII of the Income Tax Act.

C. Revenue-producing real estate

1. Overview

In general terms, a direct foreign investor in Canadian revenue-producing real estate may elect to be taxed on either a net basis at regular rates of tax or pay a flat 25% withholding tax on gross rents; this is considered below in section 3. Full implications of Canadian tax results including issues of corporate taxes on capital are beyond the scope of this paper.[90]

The precise circumstances of the investment may affect to a considerable extent the overall results. The variables include the status of the investor (that is, individual versus corporation and in the latter case whether the Canadian rental property investment is a principal or ancillary activity), the size and nature of the property, the manner in which it is leased (gross lease versus net lease, single tenant or multi-tenants), and the manner in which it is managed (which may range from little if any under net leases, to independent property managers or the maintenance of a full time staff). Some of the variables and some of the effects arising thereunder are briefly reviewed herein.

Assessment of all factors determines whether the investment should be made directly by the foreign investor, through a Canadian resident company or perhaps through a Canadian resident trust: the factors include effects under Canada's domestic law and the extent to which a treaty may alter the results. Recent treaties largely permit Canada to fully apply its domestic law in respect of foreign investment in Canadian real estate held directly or through Canadian corporations.[91]

2. Financing considerations

The financing objectives are normally twofold: maximize the deductibility of interest expense in computing Canadian taxes on rental income and minimize Canadian withholding taxes on interest paid to non-resident lenders in order to minimize the cost of borrowing. The basic considerations and factors underlying these objectives have been considered in Part I, and in relation to investment in Canadian real estate may be summarized as follows (regard also being had to certain additional factors particular to real estate investment):

- Interest expense will generally be deductible where

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84. It is assumed that the helicopter is leased on a net basis (the lessee assuming full responsibility for its maintenance and operation) comprising circumstances where the rental income should generally not be considered to be derived from carrying on of business in which case Part XIII of the Income Tax Act – Section 212(1)(d) and not Part I of the Income Tax Act will apply, resulting in a flat 25% withholding tax on the gross lease payment, subject to reduction under applicable treaty, if any.

85. Constitution of the trust would be governed by English common law principles in all provinces other than the province of Québec, in which it may be difficult to utilize the provisions of the Civil Code to constitute a commercial trust: see the Supreme Court of Canada in *Crown Trust* v. *Higher* (1977) I S.C.R. 418.

86. The trust will be considered resident in Canada: *Thibodeau* v. *The Queen* 78 D.T.C. 6376 and subject to Part I tax as an "individual" (section 104 of the Act).

87. Normally, a helicopter could be depreciated at rates of 25% per annum on a declining balance basis under the Income Tax Regulations and pursuant to paragraph 20(1)(a) of the Income Tax Act with the trust being entitled to such part of the maximum claim as is required to eliminate taxable income.

88. See Resolutions 95 and 101 of Notice of Ways and Means Motion, 1981 Budget.

89. In the latter circumstances noted, the trust income is considered as "payable" under subsection 104(24) and may thus be deducted in computing the trust's own income for purposes of Part I under section 104(6), thus giving rise to Part XIII withholding tax in respect of taxes payable by the beneficiary under Sections 212(1)(c), and (11) and 214(3)(f). (It is important to note that a trust is not entitled to reduce its income for purposes of Part I of the Income Tax Act in respect of income "payable" if the income is derived from Canadian real estate rentals, resource activities, businesses carried on in Canada or the disposition of "taxable Canadian property". None of these restrictions however could apply in the hypothetical case under consideration.) Care would be required in drafting the income interests to ensure that the amount "payable" is net of depreciation.

90. For a detailed study of this topic see "Investment in Canadian Real Estate by Non-Residents", a paper written by André Gauthier and Nathan Boidman, delivered to the Corporate Management Tax Conference of the Canadian Tax Foundation in June 1977 by André Gauthier and appearing in the Conference Report at page 195; a number of changes since the date of writing have not substantially altered the rules and results analyzed therein.

91. Present treaties with the U.S., Netherlands, Sweden and Finland can provide some interesting planning possibilities with respect to disposition gains, but as noted (note 7) these treaties are now being renegotiated.

the investment is acquired by a Canadian resident corporation or trust or, in a case of direct foreign investment, the revenue property is considered to comprise a business in Canada, or in the absence thereof a net income election is made.[92] The constraints are the thin capitalization rules where a Canadian resident corporation is involved.[93] It can also be noted that interest incurred during a period of construction can be capitalized at the option of the investor.[94]

– With respect to Canadian withholding taxes, interest paid to a non-resident lender may be subject to Canadian tax in both the direct and indirect investment structure. Where the investment is direct, and interest is paid by the foreign investors to a foreign lender, Canadian withholding tax is applied to the extent that the interest is deductible and the loan is secured by the real estate[95] or the investment amounts to the carrying on of business and comprises the principal business activity of the foreign investor.[96] Where the investment is made through a Canadian corporation or trust, withholding taxes will generally apply.[97] In both the direct and indirect context if a corporate investor is involved exemption may arise under the 5-year rule.[98]

Participating or bonus financing arrangements, whereby a lender receives an interest in rents or eventual disposition proceeds, are being used more frequently and may arise in the context either of the financing available to the investor or may comprise the manner in which the investor makes his investment. When viewed from the former standpoint, the issues include the deductibility of contingent amounts paid under the arrangement by the investor and the extent to which a withholding tax obligation may arise. Where the context is the use of such arrangements by the investor as the means of participating in Canadian real estate, structuring issues are, in effect, the mirror image of the second consideration just noted, that is, the manner in which Canadian tax may arise on payments made to the investor under the participation arrangement or perhaps in respect of a sale of the instrument. As a general matter there is, at this time, a lack of precise law on this point, either under the Income Tax Act or in the cases, and it will be necessary to rely on the principles already discussed. The main issues will involve the questions of whether the participation should be treated under rules relating to loans, the payment of principal and interest, rules relating to joint ventures or partnerships, or some combination of the two. The particular features of the participating arrangement will have to be carefully examined in order to assess the most appropriate characterizations for and consequences under Canadian tax law.[99]

3. Selecting the regime of taxation

Normally, it would be desirable to be taxed in Canada on a net income basis. As already noted such treatment may be achieved regardless of the investment structure. It applies automatically where a Canadian resident corporation or trust is involved, and, in the case of direct investment, the foreign investor may opt for net income taxation by making an election under section 216 of the Income Tax Act if the activity is not considered to be the carrying on of business.[100] This may be contrasted to the difficulties foreign investors may have in regard to rents derived from moveable or personal property and the alternate strategies required and the specific need of utilizing the Canadian resident trust.[101]

Where the investment is direct, regardless of whether it amounts to the carrying on of business or net income elections are made under section 216 of the Act, withholding tax obligations may arise in the hands of the payor (lessee) of the rent (or Canadian agent of the lessor); these rules must be coordinated with the substantive tax regime selected. For example, in the case of direct investment amounting to the carrying on of business in Canada, a certificate would have to be obtained by a lessee under section 805 of the Income Tax Act Regulations made pursuant to subsection 214(13) of the Income Tax Act in order that there not be withholding taxes (which the investor would then have to claim as a refund upon filing an income tax return for the taxation year). Or where the section 216 election is involved, a lessee would have an obligation to withhold the 25% of gross rents, again causing the investor to suffer a reduction of cash flow and claim a refund on a tax return for the year; however, an intermediate regime of withholding, applicable to net cash flow available from the gross rents, may be opted for under subsection 216(4) of the Act by the filing of appropriate undertakings and forms by a Canadian agent with and on behalf of the foreign investor.

4. Cash flow

Canadian tax on cash flow, whether or not represented by taxable income, does not arise in the case of direct investment; for example, there are never Canadian withholding taxes on dividends or distributions made by a non-resident corporation to a non-resident shareholder. However, where the investment is made through a Canadian resident corporation, any distribution, whether or not represented by underlying net rental income, would

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92. With respect to carrying on of business, see note 24 above and related text; with respect to net income election, see section 21t of the Act and next section.
93. Subsection 18(4) and following of the Act. See section II above.
94. Section 21 of the Act.
95. Paragraphs 212(1)(b) and 212(13)(f) of the Act.
96. Paragraphs 212(1)(b) and 212(13.2) of the Act.
97. Paragraph 212(1)(b) of the Act.
98. Subparagraph 212(1)(b)(vii), see note 56 and related text, bearing in mind that the exemption is scheduled to expire at the end of 1982 with the result that interest on loans entered into after 1982 will no longer be exempt.
99. Regard should be had to Resolution 151(b) of the 12 November Notice of Ways and Means Motion which excludes contingent interest payments from the 5-year exemptive provisions of subparagraph 212(1)(b)(vii). Thought should be given to the interrelationship between this new rule, the case-made rule that participation payments may not, in the first instance, have the character of interest and, therefore, whether the new Budget rule will have application. In this context, regard may also be had to paragraph 212(1)(d) dealing with rent or royalty payments and whether it can have applicability to participating payments under the bonus debt arrangement.
100. As discussed earlier, net income taxation, under Part I of the Act, applies, without need of an election if the rental property amounts to a business, under characterization criteria evolved in the case law.
101. See section III B respecting the use of a Canadian resident trust.

be subject to dividend withholding taxes under Part XIII of the Income Tax Act.[102]

5. Dispositions generally

Any disposition of an interest in Canadian real estate will be subject to Canadian tax except in the case of the sale of shares of a non-resident Canadian corporation owning Canadian real estate or a beneficial interest in a trust not resident in Canada. All corporate liquidation procedures give rise to tax in the hands of the distributing or liquidating corporation, instalment sale reserves do not apply to non-residents who do not or cease to carry on business in Canada and tax-free exchanges of real estate are not permitted. Both direct and indirect dispositions are normally subject to the taxable disposition rules detailed to some extent in the first part of this paper. Aside from exemptions under a few of Canada's treaties,[103] the use of straight debt financing as a means of sheltering income including gains and the uncertain possibilities with respect to participating debt arrangements, strategies in structuring investments from the disposition standpoint will normally relate to differentiating aggregate Canadian tax burdens which may arise under different structures selected and normally within a relatively limited range of possible results, the average Canadian tax burden on gains realized from disposition of revenue property ranging from 25% to 35%.[104]

SUMMARY COMMENT

It is apparent that effective structuring of foreign investment and business operations in Canada requires identification and adroit use of a host of rules and factors, arising under both domestic law(s) and treaty(s). In most situations careful planning should improve the results which would otherwise be realized.

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102. It is important to note for those who also invest in U.S. real estate that the distribution rules in Canada are quite different. Under U.S. law a distribution by a U.S. corporation may be taxed either as a dividend to the extent of underlying earnings and profits, per sections 301 and 316 of the Internal Revenue Code, or a capital gain to the extent in excess of earnings and profits and cost base in the shares of the payer corporation, pursuant to sections 301(c)(3) and 897; in Canada, in contrast, there is, as already noted in the text, no reference made to underlying earnings and profits in respect of corporate distributions with all such distributions being taxed as dividend, under subsection 212(2) of the Act.

103. See note 91.

104. Factors, discussed earlier, which can differentiate the overall results include dividend distribution rules, branch tax (Part XIV of the Act) considerations and taxes of the different provinces.

CANADA: Summary of Modifications in Draft Legislation

(Finance Department Release of 28 June 1982)

The Honourable Allan J. MacEachen, Deputy Prime Minister and Minister of Finance, today tabled in the House of Commons comprehensive Notices of Ways and Means Motions relating to the budget of 12 November 1981. The motions set out the draft income tax legislation to implement proposals of that budget.

The draft legislation reflects the modifications to the budget measures announced by Mr. MacEachen on 18 December 1981. It also contains further alterations reflecting many of the constructive suggestions received over the past several months.

The legislation is being issued in draft form to afford those taxpayers whose interests are affected and their professional advisers an opportunity to review the proposed amendments and suggest modifications to ensure that the changes do not have unintended or inappropriate effects. Mr. MacEachen said that in order to provide ample time for review he would not be proceeding with final legislation in Parliament until after the summer recess.

The practice of tabling draft legislation in the form of comprehensive Notices of Ways and Means Motions was proposed in the document entitled "The Budget Process: A Paper on Budget Secrecy and Proposals for Broader Consultation" issued in April. In that document the Minister said this procedure, which has been followed in recent years, provides an opportunity for significant input by the public and the legal and accounting professions in the development of tax legislation.

Interest expense

The Minister said that a committee of tax professionals has been appointed to review proposals in Resolutions 23 and 24 of the November budget involving the deduction of interest expense. Their effective date is being postponed pending the review and would not in any event apply before 1983.

Standby charge and corporate distributions tax

More significant modifications to earlier proposals include a reduction of the automobile standby charge from 2½% per month to 2% and a postponement of the 12½% corporate distributions tax to 1 January 1983. The automobile standby charge is used in calculating the benefit to an employee from the personal use of a company car. The corporate distributions tax is intended to adjust for the difference between the rate of tax paid by certain small business corporations and the amount of the dividend tax credit to which shareholders are entitled when earnings are distributed.

Charities and insurance measures delayed

Draft legislation relating to charities and to the tax treatment of life insurance policies is delayed as a result of the extensive discussions that have taken place with representatives of both interests. Details of changes relating to life insurance taxation are outlined in a separate press release. The Minister said proposed amendments in these areas would be made public as soon as they are available.

Forward averaging

There are modifications in the draft legislation to the proposals relating to forward averaging which will improve its effectiveness. Forward averaging is a method of averaging tax rates so that someone with an unusually high, non-recurring income is not taxed at an excessive rate. The changes in this area will extend the application of forward averaging to all income earned by artists and athletes from their activities as such.

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Working with Canada's Statutory and Discretionary Industrial and Petroleum Assistance Programs

by Peter McQuillan

Peter E. McQuillan, born and educated in Toronto. Attended the University of Toronto and graduated Magna Cum Laude in Commerce and Finance in 1962, winning the Toronto Stock Exchange prize in corporation finance. Joned Touche Ross & Co. in 1962. Became a member of the Institute of Chartered Accountants of Ontario in 1965. Joined Ernst & Whinney in 1968 – Admitted to partnership in 1972. National Tax Partner from 1973 to 1981. Managing Partner of the Toronto Office – October 1, 1981. Selected as a Fellow of the Institute of Chartered Accountants of Ontario in 1976. Chairman, 1980-81, of Taxation Committee of the Canadian Institute of Chartered Accountants. President, 1980-81, of the International Fiscal Association (Canadian Branch). Special lecturer in Taxation and Corporation Finance at the University of Toronto from 1966 to date.

Author of "Going Public in Canada – The Facts and the Fads" (published by the Canadian Institute of Charterd Accountants); "Federal and Provincial Industrial Assistance Programs in Canada" (published by CCH Canadian Limited); and "Investing in Canadian Films" (published by CCH Canadian Limited); Co-Author with Graham Donald of Ernst & Whinney of the book called "Valuation of Business and Canadian Tax Reform" (published by CCH Canadian Limited); Co-Author of "Your Federal Sales Tax Check-Up" (published by CCH Canadian Limited); "Sources of Venture Capital – A Canadian Guide" (a publication by the Department of Industry, Trade and Commerce (Government of Canada)); "Financing Corporate Acquisitions" (published by Butterworths); and "Purchase and Sale of a Business" (published by the Canadian Institute of Chartered Accountants).

Canada, like many industrialized nations of the world, makes available a vast array of assistance programs for both industrial enterprises and for petroleum development. At last count there were in excess of 300 federal and provincial government assistance programs for industrial development alone. The nature or type of assistance available ranges from non-repayable grants to ongoing subsidies, from incentive loan terms to income tax concessions. Programs may be characterized as either "incentive" in nature (i.e. reduced interest rate loans, outright grants, accelerated write-offs, etc.), or "last resort" in nature (i.e. government loan guarantees where debt security is insufficient for private sector lenders).

I. INDUSTRIAL ASSISTANCE

It is important to gain an understanding of several parameters within which Canadian government assistance programs operate. Of utmost importance to the non-Canadian reader is the fact that Canada has, over at least the last decade, evidenced a high degree of nationalistic and even protectionist economic policy. Foremost amongst such policies is Canada's Foreign Investment Review Act (FIRA). By rendering reviewable all new business start-ups and most acquisitions of control of a Canadian business, the Agency has significant power to influence the degree of competition in Canada. Within the context of government assistance programs this nationalistic flavour is apparent in one key way: the number of programs available to a foreign-controlled business, as opposed to the number available to a Canadian-controlled business, is dramatically reduced. Just as important, however, is the fact that the amount of funding available to foreign-controlled businesses as a percentage of total funding is not reduced so dramatically. In fact a Canadian subsidiary of a foreign company may be restricted in approximate terms to, say, 15% or less of the available programs in terms of number of programs, but will still qualify for well over 50% of government funding in terms of gross monetary incentives available in any one year.

A second key characteristic of Canadian government programs is the distinction between "statutory" programs and "discretionary" programs. The former type of incentive refers to those found in the various taxing statutes of Canada (primarily the Income Tax Act of Canada). These incentives differ from the second category in that they are part of the laws of Canada, and thus a taxpayer (whether Canadian or foreign-controlled) has a legal right to them provided the rules and regulations governing their administration are complied with. One major example of an incentive of this type is the federal investment tax credit program. New manufacturing and processing equipment, current and capital expenditures for research and development, and certain railway, air, water and long-haul land transportation equipment qualify for credits against income taxes otherwise payable in ranges of 5 to 50% of the eligible expenditures. The exact credit varies according to either the nature of the expenditures, the size of the taxpayer, or the geographic location of the taxpayer in Canada.

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Discretionary incentives are significantly different in that there is no legal right to assistance which may be available. A prospective recipient of this type of assistance must enter into an application process administered by any one of a number of government agencies or departments. Thus the success in obtaining assistance of this nature, and even the precise magnitude of the eventual assistance, is left to the discretion of program officials who act according to their perception of the specific circumstances surrounding that application.

By and large, discretionary programs are more difficult for foreign companies to qualify. Generally speaking, the economic benefit provided by a project proposed by a foreign-controlled entity must be significant enough to more than compensate for the potential negative (nationalistic) reaction often associated with granting assistance to a non-Canadian company.

Some final general characteristics worthy of note are:

(a) Canadian government incentives are usually geared to stimulate change in the enterprise, as opposed to maintaining the status quo;

(b) last resort assistance is available to prevent companies from becoming insolvent;

(c) true "incentive" assistance is available only in circumstances in which new initiatives are being proposed or in which corporate growth is sought.

Theoretically, the incentive becomes the inducement to act in a way which brings positive economic benefit to Canada. By the same token, every effort is made to ensure that incentive assistance is not given to situations in which a company would have gone ahead with a project irrespective of the availability of incentive assistance. Program officials administering discretionary incentive programs, however, are very careful to avoid granting assistance in situations where no inducement is felt to be necessary. Failure to demonstrate a need for an inducement is often the cause of otherwise eligible projects not receiving incentive assistance.

The number of programs and their various underlying objectives, administration and sensitivities are ever-changing. Thus it is difficult, and sometimes misleading, to attempt too specific an analysis of this topic at any one point in time.[1] Rather, the foreign business person interested in this aspect of Canada's business climate is better served by an overview of the key general characteristics of the major government programs.

Perhaps the best means to effect this type of overview is by examining an actual case example of a multinational corporation operating in Canada. The case discussed below involves a fairly common corporate situation for a multinational manufacturing company. Please note that while this narrative represents an actual situation, certain facts have been omitted or altered so as to preserve client confidentiality.

MAC Consolidated Inc. is a major, diversified, Canadian public corporation, which is controlled by a large foreign multinational. MAC's proposed project encompassed a $10 million modernization of one of its significant manufacturing divisions. This division employed in excess of 300 people and was located in a relatively small community in a region of Canada designated under the Regional Development Incentives Act (RDIA). This latter designation qualified the region as being one characterized by generally high unemployment and slow economic growth. Approximately 75% of Canada is similarly designated (i.e. all of the Maritime Provinces; Saskatchewan; Manitoba; most of Quebec; and the northern segments of Ontario, Alberta and British Columbia).Companies either presently located in RDIA regions or contemplating locating in them are eligible for incentive assistance in the form of outright grants for expansions, start-ups or modernizations. A modernization is intended to increase the productive abilities and efficiencies of a company as well as to strengthen medium to long term viability.

MAC proceeded to seek parent company approval for modernization of the subject division in order to ensure the commercial and competitive viability of the operation for at least another 10 years. The alternative to modernization was a gradual phase-out of the division over a 3 to 5 year period as profitability and cash flow diminished. Most of the modernization expenditures were to be capital in nature, such as the acquisition of new, more technically advanced production equipment. As a result, the company automatically qualified for a number of statutory incentives. These included a 10% investment tax credit based on total capital costs; a 2-year write-off (for tax depreciation purposes) of all manufac-

1. For specific details on every program please refer to the current edition of "Industrial Assistance Programs in Canada, 1981-1982", by Ernst & Whinney; CCH Canadian Limited.

turing equipment purchased and duty remission on a significant portion of the equipment which had to be imported from the U.S. because comparable equipment was not available in Canada. Despite the benefits of the above incentives, as incorporated in the capital expenditure proposal and pay-back calculation, the parent company was reluctant to approve the project because the projected return on investment from the modernized facility was not as attractive as several other investment opportunities competing for parent company approval.

Although the Canadian company was aware of the discretionary RDIA program no application for assistance had been contemplated mainly because MAC had had no previous experience in dealing with the government department that administered the program (the Department of Regional Economic Expansion - DREE). Professional advice was sought and received concerning eligibility for assistance from DREE. Facing the impending turndown from the parent company, MAC initiated application procedures with DREE.

Given the magnitude of the number of jobs at stake, and the demonstrated reluctance of the parent company to approve the modernization, the DREE officials moved very quickly to review and approve a maximum non-repayable modernization grant of 20% of approved capital costs, or $1.9 million. Although a DREE grant is taxable in the sense that it reduces the overall capital costs available for future tax depreciation; it nonetheless improved the project's return on investment to a point where it made sense from an internal corporate point of view. The parent company subsequently approved the Canadian company's capital expenditure proposal and the modernization was completed.

The above case illustrates a number of useful points in addition to those covered in general terms earlier. The geographic location of a proposed project is extremely important because of the wide range of economic conditions in Canada. Regional development is a high profile concern of both the federal government (DREE is a federal department) and every provincial government. Further, when regional development is being enhanced, foreign ownership of the applicant company is usually of only minor concern. Likewise, applications to FIRA proposing a location in one of these areas are usually much more acceptable than those proposing locations in areas such as industrialized Southern Ontario (including Toronto). The size of a proposed project, and thus the economic impact, is also of critical importance for obvious reasons. Had only 50 or less jobs been at risk instead of over 300, it is unlikely that the project would have received the immediate attention that it did. At a minimum, the company probably would not have received a maximum modernization grant. Again, size can go a long way in tempering concern over foreign ownership.

Prior approval is necessary in virtually all incentive application situations. Had the above project proceeded in any tangible form prior to receiving official DREE approval, the application for assistance would have been automatically rejected in full. The incentive applied for must always be viewed by government as the inducement for the company to act.

In addition to regional development and job creation/protection, governments in Canada have other high profile concerns as evidenced by the nature of other specific incentive programs. Foremost among the other areas of concern are enhancement of Canada's technological capabilities. There are significant statutory and discretionary incentives in place to encourage research and development. Foreign controlled companies can qualify for such assistance provided that the technology to be developed is commercially exploited from Canada (i.e. world product mandates for Canadian subsidiaries of foreign companies).

Another large area of concern which is common to any industrialized country is our Balance of Payments position. The creation of exports or the replacement of imports is always an important ingredient in qualifying for government assistance. The magnitude of a project's proposed impact on the Balance of Payments is again a key concern for foreign companies contemplating efforts in this regard.

Notwithstanding many of the comments made in this paper with respect to a foreign company's opportunity for government assistance, a significant project which addresses one or more of Canada's inherent economic concerns is always worth discussing in at least conceptual terms. Flexibility and a willingness to modify the rules of program administration will usually be exhibited when the benefits to Canada are correspondingly large.

II. PETROLEUM DEVELOPMENT ASSISTANCE UNDER CANADA'S NEW NATIONAL ENERGY PROGRAM

Canada's new and highly controversial and still evolving National Energy Program (NEP) is designed to meet three goals:

(1) the security of supply and ultimate independence from the world oil market;

(2) the opportunity for Canadians to participate in energy industries, especially oil and gas;

(3) fairness in pricing and sharing of revenues among governments and industry.

Petroleum Incentive Payments (PIP)

From the viewpoint of incentives for petroleum development, the NEP has had its most positive component with the introduction of cash grants for certain qualifying taxpayers. These new grants are called Petroleum Incentive Payments (PIP).

Petroleum Incentive Payments (PIP) were introduced under the NEP to replace earned depletion which is being phased out. They will increase as the corporate entitlement to earned depletion base additions decreases. The amount of PIP which will be received by an investor will be determined by a number of factors. These factors will be the degree of Canadian ownership – called Canadian Ownership Rate (COR, see following) – of the investor, the location of the expenditure and the date on which the expenditure was incurred. The availability of

PIPs is perceived by the Federal Government as a means of encouraging direct Canadian investment in the industry by increasing investor cash flow on a current basis.

The old system of earned depletion for oil and gas ventures favoured the more established companies that were already receiving resource income, because the earned depletion base accumulated was only deductible against resource profits. New companies having no resource profits could not immediately make use of the earned depletion base. In order to make smaller (and presumably Canadian) companies better able to compete with large, established foreign companies, the Government is phasing out the oil and gas earned depletion deduction and substituting direct grants called PIP payments. The amount of the PIP payments will be determined on the basis of COR, type and location of expenditures and the year in which the expenditure is incurred.

PIP summary

Qualified persons who incur eligible expenses on oil and gas exploration and development in Canada or who incur eligible costs in the purchase of certain assets can obtain PIP payments.

The amount of the PIP incentives will depend upon the:

(a) COR of the applicant;
(b) Canadian control status of the applicant;
(c) location of the expenditures;
(d) type of expenditures;
(e) year in which the expenditures are incurred.

Individuals, corporations, partnerships and trustees are qualified persons eligible to apply for the PIP incentives. Persons who are income tax exempt at the time the eligible expenses are incurred are not eligible for PIP incentives in respect of such expenses, other than the 25% Crown Share Incentive for exploration expenses on Canada Lands. Pension trusts, pension corporations and certain deferred income plans such as employees' profit sharing plans, supplementary unemployment benefit plans, registered retirement savings plans, deferred profit sharing plans, registered edutation savings plans and registered retirement income funds, to the extent they are permitted to participate directly or indirectly in the oil and gas business, are eligible for PIP incentives.

The COR of qualified persons is reduced for PIP purposes by the number of percentage points of the applicant that are attributable to ineligible persons.

There are 4 steps in determining the amount of the PIP incentive:

(1) calculate the amount of eligible costs or expenses;
(2) adjust the eligible costs or expenses by the appropriate adjustment factors; these adjustment factors are designed to prevent the transfer of the PIP benefits to non-Canadians;
(3) determine the appropriate PIP rate;
(4) multiply the adjusted eligible costs or expenses by the appropriate PIP rate.

After 1980, individuals will no longer earn depletion in respect of oil and gas resource expenditures. An earned depletion base will still be accumulated by individuals and corporations with respect to exploration expense in connection with mining properties. In addition, corporations will continue to earn depletion on exploration and development expenses and tangible costs in respect of prescribed enhanced oil recovery projects, oil sands and Saskatchewan upgrading plants.

Canadian ownership rate (COR)

On 22 June 1981 a discussion draft of the Energy Security Act, 1981 was tabled in Parliament by the Minister for Energy, Mines and Resources. This Act contains amendments to a number of existing Acts as well as introducing several new Acts. One of the new Acts is titled the "Determination of Canadian Ownership and Control Act" which sets out the legislation governing the determination of a person's COR and Canadian control status.

The COR is a central piece of the government's NEP and will be required to determine the applicant's PIPs, a person's ability to obtain a production permit on Canada Lands, the ability to obtain export permits for oil and natural gas, and to receive benefits conferred by means of the creation of the natural gas bank. For these purposes individuals and business enterprises will require a certificate which sets out both their COR and Canadian control status. COR means the degree of beneficial Canadian ownership of an entity as determined under the Act and the related regulations.

The COR of a particular entity will be one of the most important criteria in determining the level of PIP available to an investor. Individuals who are investors will not be directly involved in the determination process, other than that they will be required to complete information relevant to their Canadian status. In the case of corporate investors, they will be required, in most instances, to compute the COR of the corporation and forward the information to the manager of the investment. The Department of Energy, Mines and Resources has not yet made its final determination of the rules and the procedures which will be necessary, but, suffice it to say, they will be complex.

The main points of the Act and Regulations are:

1. It is a self-assessing system. The applicants determine their COR and apply for the COR certificate. The certificate will generally have a 1-year term.
2. Deemed CORs are provided in certain circumstances.
3. Non-public enterprises must make inquiry from all investors.
4. Public enterprises use an approximate COR based on the COR of a sample of the outstanding equity.
5. The required accuracy of measurement by an investor depends on the proximity to the applicant and the existence of special relationships.
6. Formal classes of shares must be combined where appropriate. Uncombined classes are measured separately and the results are averaged to obtain the COR.
7. The COR of optionees and owners of convertible securities will in certain circumstances be considered in the COR measurement of the applicant as well as "informal equity" such as overrides and management fees.

Basic scheme for COR determination

An applicant for a COR certificate is required to calculate its COR by applying the COR of each of its investors to the portion of the equity of the applicant owned by each investor. It is up to the applicant to make inquiries from investors as to the investors' COR. An investor that has been requested to supply its COR to an applicant is, in turn, required to calculate its COR either by applying one of the permitted deeming provisions or by applying the COR of each of its investors to the corresponding proportional ownership of equity.

This process of successive inquiries is pursued until a deeming provision is found to apply or an individual investor is identified. Generally, the inquiry will be cut off at the second level of investors. Inquiries are made to owners of shares as at one specific date. The application must be submitted within 120 days of the specific date chosen. Changes in share ownership will generally be ignored unless the result is a decrease in the COR of more than 1%. The COR certificate, when issued, will otherwise have a 1-year term. If an applicant's COR increases substantially, it may apply for a new certificate.

Qualified applicants

The following are qualified to apply for a certificate:

(a) an individual other than a non-eligible person;
(b) a corporation incorporated in Canada;
(c) a partnership constituted under the laws of a province;
(d) a trustee with respect to a trust, if the trustee and beneficiaries are, with respect to their status as such, governed by the laws of Canada or a province;
(e) an insurance company incorporated in Canada in respect of its segregated fund within the meaning of the regulations;
(f) any person prescribed as being qualified to apply for a certificate or who falls into a class of persons prescribed as being qualified to apply for a certificate.

Non-eligible person

For the purpose of this Act the expression "non-eligible person" has the same meaning as it has under Section 3 of the Foreign-Investment Review Act and the regulations made pursuant to that Act, with one exception.

A non-eligible person for the purposes of COR means:

(a) an individual who is neither a Canadian citizen nor a permanent resident within the meaning of the Immigration Act, 1976 and includes a Canadian citizen who is not ordinarily resident in Canada who has applied for citizenship of a country other than Canada;
(b) the government or agency of a government of a country or a political subdivision of a country other than Canada; or
(c) a corporation incorporated in Canada or elsewhere that is controlled in any manner, directly or indirectly, by a person or group of persons described in paragraphs (a) and (b) above.

The exception is that for the first 5 years after this Act comes into force, a permanent resident who has been ordinarily resident in Canada for more than 1 year after the time at which he first became eligible to apply for Canadian citizenship will be considered not to be a non-eligible person for the purposes of the COR determination.

Looking at the definition from the positive rather than the negative viewpoint, one could say that a Canadian citizen ordinarily resident in Canada or a landed immigrant is a qualified applicant.

Canadian control status

The question of Canadian control status, although related to the COR, is determined independently of the COR rules.

Presumption

In determining the control status of a partnership or trust, the partnership or trust will be deemed to be a corporation incorporated in Canada or elsewhere, the interests in its capital or income will be deemed to be shares of a corporation and the beneficial owners of those interests will be deemed to be shareholders of the corporation. The trustees of a trust will be deemed to be members of the board of directors of the corporation.

Control status

Pursuant to the regulations, an individual, a corporation, or a partnership or a trust, either of which is deemed to be a corporation, is Canadian controlled if he or it is not a non-eligible person.

Control of a corporation is often defined by reference to the ownership of the number of shares which represent a majority of the voting rights in a corporation. For instance, the Canada Business Corporations Act (CBCA) provides that a corporation incorporated under the Act is controlled by a person who beneficially owns more than 50% of the shares to which are attached the votes that may be cast to elect directors and who is in the position to elect a majority of the directors of the corporation. The various provincial statutes have similar provisions relating to control. Control defined in this manner by the CBCA and by the provincial statutes is generally referred to as "legal control" (de jure).

The Foreign Investment Review Act provides that a corporation is a non-eligible person if it is controlled in any manner that results in "control in fact" (de facto) by an individual or government that is a non-eligible person, or by a group of persons, any member of which is a non-eligible individual or government, whether directly through the ownership of shares or indirectly through a trust, a contract, the ownership of shares of any other corporation or otherwise. In many cases, de jure and de facto control, in fact, may be synonomous. In other cases, the identity of the person or persons who control the corporation will depend upon a factual determination of who effectively controls the corporation.

Location of expenditure and types of expenditures – Eligible costs and expenses

Eligible expenditures incurred on or after 1 January 1981 fall into three categories:

(1) eligible exploration expenses;
(2) eligible development expenses;
(3) eligible asset costs.

In general, expenses are eligible exploration expenses and eligible development expenses if they fall within the definitions of Canadian exploration expense or Canadian development expense in the Income Tax Act. However, expenses in respect of a mineral resource (including oil sands), as defined in the Income Tax Act, do not qualify as eligible exploration or development expenses.

Eligible asset costs include capital costs incurred in the construction or improvement of a heavy oil upgrader or a tertiary oil recovery project located in Canada.

Generally, Canada Lands will include all northern and offshore areas. One of the reasons for the distinction in the rates of PIPs is the fact that the federal government collects no royalties from provincial lands.

Year in which expenditure is incurred

The amount of any PIP attaching to an expenditure must be accrued in the year the expense is incurred so as to reduce the balance of CEE and CDE available, whether or not the payment has been applied for or received. The PIP follows the relevant expenditure and, accordingly, will be available to an investor regardless of the nature of his investment.

The following chart illustrates the entitlement of PIPs for the various possible combinations of the factors.

Transition period for phasing in incentive payments

Year starting 1 January	*Level 1*	*Level 2*	*Level 3*	*Level 4*
1981	50%	50%+	60%+	65%+
1982	50%	50%+	61%+	67%+
1983	50%	50%+	62%+	69%+
1984	50%	50%+	63%+	71%+
1985	50%	50%+	64%+	73%+
1986	50%	50%+	65%+	75%+

Levels of incentive payments for oil and gas exploration and development

	Provincial lands				*Canada lands*			
	Level				*Level*			
Exploration	*1*	*2*	*3**	*4*	*1*	*2*	*3**	*4*
1981	nil	nil	25	35	25	35	65	80
1982	nil	10	25	35	25	45	65	80
1983	nil	10	25	35	25	45	65	80
1984	nil	15	25	35	25	50	65	80
1985	nil	15	25	35	25	50	65	80
1986	nil	15	25	35	25	50	65	80
Development								
1981	nil	nil	15	20	nil	nil	15	20
1982	nil	nil	15	20	nil	10	15	20
1983	nil	10	15	20	nil	10	15	20
1984	nil	10	15	20	nil	10	15	20
1985	nil	10	15	20	nil	10	15	20
1986	nil	10	15	20	nil	10	15	20
Non-conventional, etc.								
1981	nil	nil	15	20				
1982	nil	10	15	20				
1983	nil	10	15	20				
1984	nil	10	15	20				
1985	nil	10	15	20				
1986	nil	10	15	20				

* Level 3 is an addition to the PIP system. Levels 1, 2 and 4 were announced in the NEP.

PIP — The role of the province of Alberta

The PIP was initially conceived and was to be administered wholly by the federal government. The September 1981 Memorandum of Agreement between the Government of Canada and the Government of Alberta relating to energy pricing and taxation indicated that the Government of Alberta would administer and pay the incentives under the program for activities within Alberta. The Government of Alberta will have the authority to make its own rules with respect to the administration aspects of the Alberta portion of the PIP.

Any change in PIP incentives rates as specified in the NEP for activities on provincial lands will require agreement between the Government of Alberta and the Government of Canada.

Similar agreements have been entered into by the federal government and other provinces; however, Alberta is the only province administering and paying the PIP incentives itself.

Canadian exploration expense (CEE)

Canadian exploration expenses (CEE) which are eligible for a discretionary 100% write-off in the year incurred include:

(1) the costs of geophysical, geological and geochemical expenses incurred in order to determine the existence, location, extent or quality of a petroleum or natural gas accumulation in Canada;

(2) expenses incurred prior to 1982 in drilling or completing or preparing a site for an oil or gas well in Canada, if the expense was incurred in the year or in a prior year and, within 6 months of the completion of the drilling, the well is:
   (a) determined to be the first well capable of production from a previously unknown accumulation; or
   (b) it is reasonable to expect that commercial production will not commence within 12 months of completion (primarily in the case of gas or frontier properties where production permits are unavailable or production is not feasible, commonly referred to as "shut in");

(3) expenses incurred after 1981 in drilling or completing a well as in (2) if drilling is completed within 6 months of the year end and the well is abandoned within 6 months of the year end and 12 months of its completion;

(4) expenses incurred after 1981 in drilling or completing an oil or gas well in frontier areas, unless the well was drilled to obtain commercial production from a known accumulation or for the purpose of delineating a field or determining the extent or quality of the accumulation and the drilling was commenced after commercial production commenced.

The amount of an investor's CEE available for deduction is reduced by the value of any assistance or benefits received in the form of government grants, subsidies, benefits, etc., received after 25 May 1976 (see below, discussion of PIP and small explorer's credit). CEEs will be available to an investor who invests directly in a joint venture, limited partnership units, flow-through shares or shares of a joint exploration corporation.

Canadian development expense (CDE)

Canadian development expenses (CDE) which are eligible for a discretionary deduction at, effectively, a 30% rate on the declining balance basis include:

(1) expenses incurred to drill or complete a well to the extent the expenses are not CEE;
(2) expenses to drill or convert a well to assist in production from an oil or gas well (this includes a wide variety of wells drilled or converted for stimulation of production);
(3) expenses for drilling or recompleting a well after the commencement of production;
(4) payments made to acquire Canadian resource properties prior to 11 December 1979.

CDEs will be available to an investor regardless of the form of his investment. Any government assistance received after 25 May 1976 will reduce the investor's CDE balance in the same fashion as described for CEEs above.

Canadian oil and gas property expense (COGPE)

Canadian oil and gas property expenses (COGPE), which are eligible for a discretionary deduction on the basis of a 10% declining balance, are the costs of acquisition of a Canadian resource property (see below) or a right to or interest in such a property. While the initial cost of acquiring a resource property is COGPE, any costs incurred in preserving the right are not COGPE, but rather are lease rentals and as such are not eligible for any deduction by virtue of paragraph 18(1)(m) of the Income Tax Act.

The balance of COGPE will be reduced in the same fashion as CEE and CDE with respect to the value of any grants or assistance received. Similarly, COGPE will be available to any investor regardless of the form of his investment.

Canadian resource property

A Canadian resource property includes any property, acquired after 1971, which is a right, licence or privilege to explore for, drill or take petroleum, natural gas or related hydrocarbons in Canada. In addition, a Canadian resource property includes a right, licence or privilege to store petroleum, gas or related hydrocarbons underground as well as any oil or gas well in Canada. Finally, the definition includes any rental or royalty which is computed by reference to the amount or value of production from an oil or gas well in Canada and any right or interest in any such property including the right to receive proceeds of disposition of any property described above.

Foreign exploration and development expense

Foreign exploration and development expense is subject to reasonably complex rules with respect to the amount of any claim by an investor. Foreign exploration and development expenses include expenses incurred for geological or geophysical exploration or drilling in respect of petroleum or natural gas outside Canada as well as any annual payments made to preserve a foreign resource property (the definition of foreign resource property is the same as the definition of Canadian resource property, except that it is outside Canada) and payments to acquire a foreign resource property. There is no provision to reduce the balance of foreign exploration and development expense for the value of any government assistance received. Foreign exploration and development expenses can only be incurred by a taxpayer through a direct investment, a joint venture or a partnership.

The deduction for foreign exploration and development expense is limited to the lesser of the taxpayer's foreign exploration and development expense account balance and the greater of:

(a) 10% of his foreign exploration and development pool; and
(b) the sum of his foreign petroleum and gas production, plus his foreign oil and gas royalty revenue, plus his proceeds from dispositions of foreign resource properties included in income for the year.

Resource allowance

The resource allowance was introduced to the Income Tax Act as a consequence of the historical disagreements between the federal and provincial governments. It is designed to partially offset the disallowance for federal tax purposes of provincial crown royalties. The pegging of the allowance at 25% is premised on the assumption that a 25% net royalty to the provincial crown would result in a reasonable "take" to the provinces.

Historically, prior to the federal-provincial pricing agreements signed in the Fall of 1981, the resource allowance available to a taxpayer with Canadian production income, including royalties, was 25%. Resource profits for this purpose have been: income from production and royalty income (net of losses from these sources) net of direct costs of production (referred to as "lifting costs"), the capital cost allowance referrable to the revenue and a reasonable allocation of general and administrative expenses.

No deduction is required in calculating resource profits with respect to interest expense, CEE, CDE, COGPE or earned depletion. It should be noted, as well, that for the purposes of this calculation, disallowed crown royalties and certain income deemed by the Income Tax Act to arise with respect to transactions with the Crown are included in income.

Profits derived from the processing and transportation of petroleum and natural gas are specifically excluded from the profits eligible for the resource allowance. The former, in the case of corporate taxpayers, are eligible for the federal deduction from corporate tax for manufacturing and processing profits.

Certain amendments are to be made to the resource allowance provisions. Commencing 1 January 1982, the resource allowance will apply to a taxpayer's total production profits prior to the deduction of royalties payable to other participants in the well and a royalty owner will no longer receive the resource allowance on his royalties.

Further, draft regulations available indicate that a new category of expenses, "Canadian exploration and development overhead expenses" (i.e. administration costs relating to CDE and CEE), will not be deductible in the computation of resource profits.

Those taxpayers who have production interests whose tax liability is unaffected by non-deductible crown royalties (i.e. those individuals paying freehold royalties only) will not receive the benefit of the resource allowance after 31 December 1981. It is unclear whether those producers paying nominal crown royalties are to be affected by this change or not.

The resource allowance is available to investors in joint ventures and partnerships but not to the investor in flow-through shares or shares in a joint exploration corporation, as these investors do not have production revenues. In the case of a partnership investment, the resource allowance is claimed at the partnership and not the partner level. The deduction is a permissive one, but if it is not taken in the year in which the resource profits are earned, there is no way to carry it forward.

Earned depletion

Earned depletion is another discretionary deduction based on resource profits. Earned depletion is restricted to the lesser of 25% of resource profits, but not the same resource profits calculation as for the resource allowance, and the earned depletion base. Resource profits for this purpose include the same revenues as for the resource allowance calculation plus the proceeds of disposition of resource properties and reserves on sales of resource properties brought into income in the year.

In arriving at the eligible resource profits, it is necessary to deduct direct costs, relevant general and administration costs, applicable capital cost allowance, the interest expense applicable to the earning of the production revenue, CEE, CDE, COGPE and the resource allowance. Profits or losses from processing, transportation and transmission of oil or gas are excluded for these purposes.

The earned depletion base of a taxpayer, prior to 31 December 1980, consisted of 1/3 of all expenditures for exploration and development, regardless of where the expenditures were incurred, and 50% of all expenditures made with respect to synthetic oil and prescribed enhanced recovery projects.

Subsequent to 1980, only corporations will be able to earn further earned depletion base, although those individuals who have not fully utilized their previously accumulated earned depletion base will be able to continue to do so. The rate at which the earned depletion base will be accumulated is illustrated by the following chart.

The foregoing changes with respect to the accumulation of the earned depletion base relate to oil and gas expenditures only and not to mining operations.

In general, then, an investor which is a corporation will accumulate an earned depletion base for CEEs and CDEs incurred and expenses which have been renounced to it. There has always been a requirement to exclude capitalized interest, expenses renounced by the taxpayer and expenses recovered after 28 April 1979 and, as a consequence of NEP-related proposed amendments, it will be necessary to exclude capitalized general and administration expenses relating to exploration and development. Qualifying expenditures have never included the costs of acquiring a Canadian resource property.

	Conventional areas	
	Exploration	*Development*
After 1980 (corporations only)		
1981	33⅓	Nil
1982	20	Nil
1983	10	Nil
1984	Nil	Nil
1985	Nil	Nil

	New synthetic oil and prescribed enhanced oil recovery projects	Canada Lands
		Exploration
After 1980 (corporations only)		
1981	33⅓	33⅓
1982	33⅓	33⅓
1983	33⅓	20
1984	33⅓	10
1985	33⅓	Nil

* After 1980, eligible expenditures will be net of any relevant incentive payments

Investment tax credits

Many of the tangible properties acquired through an oil and gas investment will be eligible for investment tax credits, with the rate of the credit determined by the location where the equipment is put into service. The assets which will qualify are new assets which are machinery or equipment acquired after 23 June 1975 to be used in the operation of an oil or gas well, the processing of heavy crude oil to the stage of crude oil or its equivalent and exploration and drilling for petroleum or natural gas. Assets which do not qualify are those which are eligible for classification as CEE or CDE, such as well casing. The amount of investment tax credit claimed will reduce the undepreciated capital cost of the equipment in the year in which it is claimed.

Investment tax credits will be available only to investors who invest by way of partnerships, joint ventures or direct investment, as the capital cost of equipment cannot be renounced by a joint exploration corporation and is not eligible for the flow-through under the flow-through shares rules.

Capital cost allowance (CCA)

Capital cost allowance (CCA) is the tax equivalent of accounting depreciation. Most assets acquired by oil and gas ventures will fall into Class 10 for CCA purposes, eligible for a write-off on a 30% declining balance basis by virtue of being:

(1) either oil and gas well equipment; or

(2) property (provided it was acquired after 22 May 1979) designed principally for the purpose of determining the existence, location, extent or quality of accumulations of petroleum or natural gas, or drilling oil or gas wells.

Any storage tanks for oil acquired will be eligible for Class 29 treatment.

In the case of a partnership investment, the CCA will be claimed at the partnership and not the partner level. In the case of a direct or joint venture investment, the claim will be at the discretion of the investor; for those who invest in flow-through shares or shares in a joint exploration corporation, no CCA claim will be available to the investor.

The Budget Papers, tabled on 12 November 1981, contained proposals to restrict CCA in the year in which an asset is acquired to 50% of the amount otherwise available. Under the rules previously in existence, such CCA was prorated in the year of formation of a business venture to the proportion of the year the venture was in existence. It is unclear whether the proposal will create a compounded restriction or not. On 18 December 1981, the Honourable Allan MacEachen tabled a number of revisions to his previous Budget, some of which related to CCA. The available information is too imprecise at this time to allow for specific comment.

Interest expense

Prior to the Budget tabled on 12 November 1981, all interest expense with respect to oil and gas investments was generally treated as deductible in the year it was incurred. Resolutions 23 and 24 of the Budget contain provisions which would greatly curtail the deductions available with respect to the interest expense on certain types of investments. Because oil and gas operations are specifically included in the definition of active business income, interest expense relating to an investment in an oil and gas venture directly, through a joint venture or through a limited partnership, did not appear to be affected by the Budget. However, as the only income which an investor in a joint exploration corporation or flow-through shares could earn was dividend income, which is income from property, interest expense incurred with respect to such investments would be restricted to the dividend income earned from the shares which, in most cases, would be nil for a number of years. It appears that the Budget resolutions will now be amended in the following manner:

(1) for 1982, interest expense will be restricted only to the extent that it exceeds ⅔ of a taxpayer's total income prior to the interest expense claim;
(2) for 1983, the ⅔ will be ⅓; and
(3) there will be an additional $10,000 of interest expense which will be unrestricted for investments in taxable Canadian corporations.

All of the foregoing changes to the interest deductibility will tend to neutralize one of the biases against investment by way of flow-through shares or shares in a joint exploration corporation.

Small explorers' credit

The Province of Alberta provides certain incentives to industry participants, one of which has come to be known as the "Small Explorers' Credit". The credit is available as an offset to Alberta royalties and freehold mineral taxes. Prior to 1 September 1981, the total available for any well was $1,000,000 and from that date it will be $2,000,000. However, similar limitations apply on a per taxpayer basis. It is not necessary to have tax payable in Alberta in order to benefit from this credit and it is refundable, in cash, upon the filing of the requisite forms with a taxpayer's income tax return. Generally, the credit will be available only to direct, joint venture or partnership investors.

Forms of investment

Traditionally, the most common forms of investment offered to the public (whether through private placement or prospectus) have been limited partnership units and joint venture interests. Less common have been flow-through shares and shares in joint exploration corporations. These investment structures are discussed in the remainder of this paper.

(1) Joint exploration corporation

A joint exploration corporation is a principal business corporation which has not, since its incorporation, had more than 10 shareholders. A principal business corporation includes a corporation whose principal business is exploring or drilling for petroleum or natural gas, or the production, refining or marketing of petroleum, petroleum products or natural gas.

The method whereby an investor obtains tax benefits from his investment is through the mechanism of the joint exploration corporation renouncing its expenses to its shareholders. Expenses can only be renounced to corporate shareholders and are renounced in agreed proportions. Expenses which may be renounced are those for which payment was made by the shareholder to the joint exploration corporation in respect of CEE, CDE or COGPE.

(2) Flow-through shares

Flow-through shares are generally shares of a corporation, of a new class, issued under an agreement between the shareholder and the corporation whereby the shareholder contributes funds to the corporation to be used by the corporation to incur CEE, CDE or COGPE. The agreement specifies that the expenses are being incurred by the corporation on behalf of the investor and the expense incurred is the sole consideration for the issue of the share.

Prior to 13 November 1981, any shares issued under such an arrangement were treated for income tax purposes as inventory and not capital property, with a nil cost base. This treatment was not an unreasonable one as the expenditures in respect of which the shares may be issued are not capital property. The Budget, tabled 12 November 1981, contains a resolution which would make flow-through shares, issued after 12 November 1981, eligible for treatment as capital property (however, the shares will still be subject to the ordinary tests of income vs. capital). It is thought that this proposed amendment was to compensate for some of the proposed amendments to the reorganization provisions outlined below.

When CEE and CDE are incurred by investors in flow-through shares, the investors are entitled to the PIP incentives. The corporation will act for the investor in filing the application and receiving the incentives. The relevant COR is that of the corporation issuing the shares. A joint exploration corporation is a qualified person and entitled to incentives in its own right.

(3) Limited partnership

The limited partnership has become a popular vehicle for tax shelter investment because it allows for a full flow-through of tax deductions, while limiting the liability of the investor to the amount of his capital subscription. Because of this limitation of liability, it is Revenue Canada's position that an investor may not claim further deductions for income tax purposes when his adjusted cost base in the limited partnership is nil or negative. A limited partnership will be governed by the relevant law in the province of its formation.

Converting the investment to liquid form

Prior to the Budget tabled 12 November 1981, it did not matter much what form the initial investment in the venture took. Generally, the investor expected, at some point, to obtain shares in the operator/promoter, which would be readily saleable. This subsequent conversion of the investment interests relied upon the tax-free reorganization provisions contained in the Income Tax Act. The Budget, tabled on 12 November 1981, would have eliminated, in most cases, the opportunity to effect these transactions on a tax-deferred basis. One of the possible rationales for these proposed changes is that, as a consequence of these transactions, it was possible to convert income gains on a disposition of the direct investments to capital gains on a future disposition of the shares received on the reorganization. With the proposed abolition of the reorganizaton provisions in these circumstances, investors, to the extent they had insufficient balances in their CEE, CDE and COGPE pools, generally from other investments in the industry, would have suffered a recapture of previous deductions.

It appears, as a consequence of the Speech referred to earlier, that the reorganization provisions will not be amended prior to 1983 and that future amendments may differ radically from those tabled on 12 November 1981.

Alberta announces new incentives in April 1982

Leading a drive to improve the industry's cash flow position is the Alberta Government's package of financial incentives, a series of royalty cuts and special grants.

The Alberta package includes a $250 million grant to offset the costs of servicing existing wells in 1982. The grant can be taxed by Ottawa as income at a rate of 36%, reducing the benefit by $90 million.

Most of the benefits from the Alberta package are earned through reductions in provincial royalty rates. Because royalties are deductible before the Incremental Oil Revenue Tax (IORT) is calculated, royalty reductions increase the amount of the tax.

The IORT is calculated on incremental revenue, the difference between the actual price paid for oil and the price established by the NEP. The average price for 1982 is $24.63 a barrel, compared with $20.25 a barrel under the NEP, so incremental revenue is $4.38 a barrel.

Because of Alberta's changes, the new royalty on incremental revenue is $1.63 a barrel and incremental income subject to IORT is $2.75 a barrel (incremental revenue less royalty). Under the old rules, incremental income is $2.43 a barrel.

The new IORT, 50% of incremental income, is $1.37 a barrel compared with $1.22 a barrel under the old rules, an increase of 15 cents a barrel.

Alberta's royalty changes give companies a benefit of $1.80 a barrel, based on average rates, so the 15% IORT portion represents 8.3% of the benefit.

Alberta Premier Peter Lougheed said any attempt by Ottawa to increase its take would be considered a breach of the energy agreement and could lead to a new confrontation between the province and the federal Government.

Because the federal portion is small, however, Alberta's opposition is considered to be more of a question of principle than a financial issue that affects the industry, in the near term at least.

The federal Government says changes to the Alberta royalty structure were noted as a possibility during the negotiations that established the energy agreement in 1981 and the province realized that IORT would increase if royalties were cut.

All federal energy taxes are under review because of falling world oil prices but no changes are expected for several months.

Other taxes – Some of the disincentives

The NEP and the federal-provincial pricing agreements have spawned a new set of taxes.

(1) Petroleum and gas revenue tax (PGRT)

The petroleum and gas revenue tax (PGRT) was introduced effective 1 January 1981. It was prior to 1982, an 8% tax on production revenue. Production revenue is computed as revenue from production (including crown royalties, but net of freehold royalties paid) net of lifting costs, without any allowances for interest, CCA or rental payments in respect of tangible property. It is necessary to file separate returns for this tax on the due date of the investor's income tax return and also, in some circumstances, to make instalments with respect to this tax.

Commencing 1 January 1982, the rate of PGRT was increased to 16%, but a resource allowance equal to

25% of production revenue is available to those taxpayers whose tax is affected by the payment of non-deductible crown royalties.

(2) Incremental oil revenue tax (IORT)

Generally, investors in new oil and gas ventures will be unaffected by the incremental oil revenue tax (IORT). The IORT is a 50% tax on the difference between the prices which would have been obtained under the NEP price schedule and the prices under the new pricing agreements. The tax is applicable only to oil production from accumulations known, prior to 1981, to exist in commercial quantities. The IORT is effective 1 January 1982 and any income subject to the IORT is exempt from income tax.

The profits for IORT purposes are reduced for related crown royalties which are calculated on a well-by-well basis, based on the average royalty rate for the well applied to the incremental revenue.

General investment considerations

Having examined various tax and incentive considerations associated with an investment in an oil and gas venture, it becomes necessary to examine the investment criteria to which a potential investor should have regard.

With the abolition of super-depletion, any investor in an oil and gas tax shelter will have a net cash investment in the project after his benefit from tax deductions.

There are a number of common-sense questions which an investor should ask. A brief checklist of some issues to be considered by a potential investor is provided:

1. A determination should be made of the amount of the promoter's "carried interest" in the project. A promoter's carried interest will be the percentage of the future profits which he earns from the investment property without incurring a proportionate amount of the costs.
2. The rate of provincial royalties which future production from the fund will suffer should be determined.
3. A determination should be made of the allocation of the various provincial drilling incentives between the promoter and the investors. If the investor is to share in the drilling incentives, he should ensure that he will be able to utilize them before they expire. If the promoter is to be the beneficiary of the incentives, the investor should ensure that he is receiving some compensation for the value of the incentives earned with his money but assigned to the promoter.
4. An investor should ensure there is a market for and a means of getting to market the production found by his investment. Many investors have invested in funds where there is no technology or availability of transportation to take the product discovered to market. The investigation should also encompass current and prospective government regulations relating to pricing, royalties, allowable production, import and export of the product and environmental protection regulations.
5. A determination should be made of the profitability, particularly in the case of gas discovered in Alberta, of the production being shut in.
6. Because of the fact that oil and gas reservoirs often extend over a number of leases, an investor should ensure that neighbouring lessors will not be able to draw upon the oil and gas on the investor's lease. This insurance generally takes the form of the driller entering into contracts with neighbouring lessors to prevent such "sucking out" of the investor's petroleum and natural gas reserves. Commonly, protection against this eventuality is accomplished by means of a "step-out" agreement, allowing the fund to drill development wells on its neighbours' properties and taking any oil or gas so found in return for a royalty, or a unitization agreement whereunder the fund obtains a share of all the oil and gas in the neighbourhood and the neighbours must reimburse the fund for its drilling expenses. These are only two of the methods of obtaining this type of protection. An investor should ensure that some form of protection has been obtained for his investment.
7. A potential investor should ensure that the geological information on which he is basing his potential investment has been provided by an independent geologist. Further, he should investigate the promoter's track record, his previous funds and their performance.
8. Some oil and gas ventures require that after a successful exploration effort, the investor will be required to provide additional funds for the development and commencement of production. An investor should evaluate his willingness and ability to contribute additional funds to the venture and the penalty for a failure to do so.

The Influence and Impact of Canada's Tax Accounting Rules on Structuring Canadian Business Operations

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1. INCOME TAXATION AND TAX ACCOUNTING IN CANADA

(a) Evolution of income tax law

Federal income iax began in Canada in 1917 with the enactment of the Income War Tax Act. This legislation, as amended from time to time, remained in force until the first major effort at tax reform, represented by the 1949 Income Tax Act. In turn, this Act, as much amended, was substantially "reformed" after the appearance of the report of the Royal Commission on Taxation (the "Carter Report") in 1967. The new legislation, still known as the Income Tax Act, came into force in 1972 and is still the applicable law, though the volume of annual amendments has been substantial.

While it was always recognized that the determination of income for purposes of income taxation would involve questions of accounting, most questions of tax accounting were left to commercial practice, and relatively few such questions were directly addressed in the earlier versions of the statute. Even today, many issues of timing and other questions of accounting practice are not directly provided for in the Act.

(b) The accounting profession and income taxation

The development of income taxation and its growing importance in the Canadian economy have been accompanied by a remarkable growth in the accounting profession. Most of the personnel who administer the law for Revenue Canada, Taxation (popularly called the "Department"), as well as most persons in the private sector who advise on tax matters, are professionally qualified accountants or have had accounting training. Consequently it is not surprising that accounting principles and practices would be generally followed in measuring income for purposes of income taxation wherever there was no specific direction in the Act.

(c) Legislating generally accepted accounting principles

In the course of the discussions leading to each of the two major "reforms" of Canadian income tax law, the question was raised whether the Act should contain a provision to the effect that, absent any specific provision in the Act to the contrary, income for purposes of the Act shall be determined in accordance with generally accepted accounting principles (GAAP). Some commentators felt that both the statute and the case law required departures from GAAP that were not necessary to protect the national revenue, that often had inequitable consequences, and that needlessly complicated taxpayers' record keeping; in their view, the proposed statutory provision would permit income measurement for tax purposes to evolve in a manner parallel to the evolution of financial accounting principles.

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On each of these two occasions, however, after consultation with the accounting profession, the government decided not to add the proposed provision to the Act. On the first occasion, the profession did not appear to have sufficient confidence that GAAP could be clearly identified in a particular case, and it was feared that such a statutory provision might lead to more, rather than less, uncertainty. On the second occasion, the accumulation of formal pronouncements by the profession on accounting principles made the earlier objection much less valid; nevertheless many accountants felt that the proposed statutory provision would have a restricting effect on the application and development of accounting principles. While the Carter Report recommended that many of the rigid timing rules in the Act be removed, so that more reliance could be placed on accounting principles in determining matters of timing,[1] even this limited recommendation was not implemented.

(d) Generally accepted accounting principles and case law

Even so, much of the pre-1950 case law supported the application of accounting practice in the measurement of income for tax purposes in cases where the Act was silent. Partly because of changes in wording implemented by the 1949 Act, which specifically recognized accrual accounting, subsequent case law came increasingly to refer to accounting principles and practices to fill gaps in the Act. With occasional exceptions, this trend has continued to the present time and has taken Canadian tax law almost to the position where it would have been if the twice-rejected statutory reference to GAAP had been enacted. In some areas, however, the case law has recognized that a taxpayer may make a choice between following GAAP and following a less sophisticated approach to timing – as was the case for prepaid expenses before recent relevant amendments to the Act.

(e) Consolidated tax returns

While the idea of permitting a group of resident corporations under common control to file consolidated tax returns has been proposed from time to time, it has always been rejected by the government because of the complexity that it is thought to entail. No simple alternative procedure is available for shifting losses between affiliated corporations, though 1977 amendments to the Act permit accumulated losses to flow through an amalgamation of corporations and the winding up of a substantially owned subsidiary into its parent corporation, subject to certain restrictions. Consequently, when losses are anticipated, such as on the commencement of a new business, there is a tendency to have the business activity in question carried on by a profitable corporation rather than by a new corporation that will have no current profits against which to offset the early losses.

(f) The "matching" principle

The accountant's principle of matching revenues and related expenses in the same accounting period has received increasing, but not total, recognition for tax purposes in both the case law and recent amendments to the Act. In several cases, on the other hand, departures from the "matching" principles that appear to be permitted may give taxpayers a choice to accelerate the recognition of expenses.[2] Perhaps largely for this reason, the Department has abandoned its earlier hostility to the use of accounting principles for deciding timing questions and is trying to insist on more general application of the "matching" principle.[3] In some areas where the Department has attained, or anticipated that it would attain, little success, such as with respect to the deferral of deduction of prepaid expenses, it has recently obtained amendments to the Act to enforce the application of the "matching" principle.

Some years ago the case law decided that the "matching" principle could not be followed in measuring annual income for tax purposes from construction contracts. The case law required that billings on such contracts less holdbacks be included in the contractor's income and that all expenses be deducted as incurred, regardless of whether they related to amounts that had been billed. For administrative purposes, however, the Department has allowed the use of the "completed contract" method where the duration of the contract is not expected to exceed two years, providing that the taxpayer consistently follows this practice for all such contracts; subsequent additions to the job that may postpone completion are regarded as separate contracts.[4] Consequently, until Departmental practice changes, a series of shorter-term contracts may be preferable, for the contractor's tax position, to a single longer-term contract.

The Act has permitted individuals to account for interest revenue on either a cash or a "receivable" basis, depending on the accounting method that they regularly follow.[5] By administrative practice, the Department also permits the accrual method of accounting for interest revenue by individuals, though it has attempted to restrict the individual's right to change from one method to another.[6] Previously these options were available to most other taxpayers, but, by recent amendment, corporations, partnerships, and certain trusts are now required to account for interest revenue by the accrual method.[7] Thus individuals, but not corporations or partnerships, could defer recognizing interest revenue by investing in deferred annuities, coupon bonds, or bank deposit certificates on which interest payments are deferred. The amendments proposed in the budget of 12 November 1981, however, will require individuals to recognize accrued interest revenue at least every third year.

The case law allowed a taxpayer that has to treat foreign

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1. 4 *Report of the Royal Commission on Taxation* 218-20 (1967). See also 1 ibid. 113.
2. See, e.g., *The Queen* v. *Oxford Shopping Centres Ltd.*, [1981] C.T.C. 128, 81 DTC 5065 (Federal Court of Appeal).
3. See, e.g., Mitchell, "Current Assessing Trends", 21 *Can. Tax J.* 256, 261 (1979); Reed, The Dilemma of Conformity: Tax and Financial Reporting – A Perspective from Revenue Canada, in *Corporate Management Tax Conf.* (Can. Tax Foundation 1981).
4. Interpretation Bulletin IT-92R, para. 12 (3 March 1975).
5. Income Tax Act, paragraph 12(1)(c). On the timing of interest expense, see paragraph 20(1)(c).
6. Interpretation Bulletin IT-396 (17 Oct. 1977).
7. Act, subsections 12(3)-(6).

exchange gains or losses on revenue account to recognize any such gains on outstanding indebtedness as of the end of each year, even though the debt might not be settled for some years.[8] While accepting this result, the Department is also prepared to accept any method of determining foreign exchange gains or losses on revenue account that is in accord with GAAP, if the same method is followed in the taxpayer's financial statements and is used consistently; in certain cases, however, the Department will accept a change to what it regards as a more appropriate accounting method for foreign exchange. A taxpayer is also permitted by the Department to choose not to recognize any foreign exchange gain or loss until the account is settled.[9]

2. Legislating conformity of tax accounting with business records

(a) An early attempt

When the present system of tax depreciation (known as "capital cost allowance") was instituted with the 1949 Act, the Regulations under that Act purported to limit the capital cost allowance that could be claimed on depreciable assets in any year to the amount of depreciation shown for the year in the taxpayer's financial statements.[10] Because diminishing balance rates of capital cost allowance were prescribed for tax purposes, allowing quite generous deductions in the early years that an asset was held, many taxpayers faced the dilemma of either recording excessive depreciation in their financial statements or postponing some of the capital cost allowance that would otherwise be available to them. Public corporations that were under pressure to avoid qualifications in their auditors' reports were at a disadvantage in this respect in comparison with closely held corporations. A growing level of protest against this rule led to its removal from the Regulations effective in 1954.

(b) Deferred taxes

A consequence of the freeing of capital cost allowance claimed for tax purposes from the amount of depreciation shown in the taxpayer's financial statements was the recognition, in the financial statements of many businesses, of growing amounts of deferred taxes in subsequent years. This recognition was required by the pronouncements of the Canadian Institute of Chartered Accountants in order to achieve a proper allocation of income tax expense to the appropriate accounting periods.[11] In the case of many corporations the deferred taxes have grown continuously and have reached very substantial levels, and all indications are that this growth will continue indefinitely. Many accountants are concerned about this result and would like to see existing accounting rules relating to tax allocation re-examined.[12] Some may argue, however, that any excess of existing deferred taxes over what might be regarded as more reasonable levels may be justified as an offset to the effect of failing to make provision in financial statements to correct the overstatement of accounting profit that results from inflation.[13]

It seems clear that the general system of capital cost allowance is widely accepted by both the Department and taxpayers, because of its simplicity of application and its relatively generous rates. Consequently it is unlikely that the tax depreciation rules will be changed to conform with depreciation for purposes of financial accounting. The solution to the problem raised by growing deferred taxes, therefore, will need to be developed by the accounting profession and is not likely to come from changes in tax law.

(c) Capital cost allowance as an incentive

The problems raised by divergent deductions for depreciation for purposes of income taxation and financial accounting can be aggravated where generous rates of capital cost allowance are granted as an incentive for taxpayers to invest in certain kinds of assets or industries. The fact that deferred taxes must be provided for in the financial statements of a taxpayer who seeks to take advantage of such an incentive may reduce the attractiveness to him of doing so.

3. "RESERVES"

The government's traditional concern about the possible use of conservative accounting principles to postpone the recognition of income is reflected in the long-standing prohibition in the Act against the deduction of "an amount transferred or credited to a reserve, contingent account or sinking fund" except where such a deduction is specifically permitted in the Act.[14] The specific provisions that allow deductions that are described in the Act as "reserves" indicate that the term "reserve" is being used in a broader and less precise way than under prevailing accounting practice in Canada.[15] According to the Department, this term when used in the Act "means more generally an amount set aside that can be relied upon for future use".[16] It might be more accurate to say that "reserve" in the Act means an expense the amount of which is only estimated or contingent as of the end of the year in question.

The restriction against deducting "reserves" has the effect of encouraging businesses to avoid contingencies applicable to the expenses that they claim or to take steps to bring themselves within the specific wording of a provision of the Act that expressly permits the deduction of a "reserve". Thus, careful documentation of executive bonus schemes appears to be necessary to ensure the current deductibility of bonuses payable.[17] A publisher or

8. *Canadian General Electric Co. Ltd.* v. *M.N.R.*, [1961] C.T.C. 512, 61 DTC 1300 (Supreme Court of Canada).
9. Interpretation Bulletin IT-95R (16 Dec. 1980).
10. Former Regs., subsection 1100(4).
11. CICA Handbook, s. 3470.
12. See, e.g. Drummond & Wigle, "Let's Stop Taking Comprehensive Tax Allocation for Granted, *CA Magazine,* Oct. 1981, p. 56.
13. See, e.g., Report of the Ontario Committee on Inflation Accounting 68 (Ont. Government Bookstore 1977); *The Budget in More Detail* 42 (Department of Finance, 12 Nov. 1981).
14. Act, paragraph 18(1)(e).
15. See CICA Handbook, s. 3260.
16. Interpretation Bulletin IT-215R, para. 12 (12 Jan. 1981).
17. Id., para. 10; Interpretation Bulletin IT-109R, subpara. 12(e); Act, section 78.

wholesaler of publications who delivers the publications to a retailer who has a right to return items that are not sold is better advised to retain title to the publications until they are sold by the retailer than to transfer title to the retailer on delivery and later take back title to the items returned: in the former case no revenue need be recognized until items are sold by the retailer, whereas, in the latter case, sale revenue must be recognized at the time of delivery to the retailer, and no deduction can be taken for estimated returns, since such a deduction would represent a "reserve" that is not specifically provided for in the Act.[18] A transaction the only purpose of which was to enable a taxpayer to qualify to deduct a "reserve" and thereby to postpone the recognition of income has been held to be effective.[19]

The budget of 12 November 1981 proposes to eliminate the "reserves" that permit the recognition of gross profit on dispositions of trading property or capital property to be spread over the period during which the proceeds are to be collected. For dispositions after the budget date, the entire taxable gain must be recognized in the year of disposition, regardless of when the proceeds fall due. This can be expected to discourage sales on terms that provide for a substantial portion of the price to be paid over a period of time.

4. INVENTORY VALUATION

The earliest attempts by Canadian taxpayers to protect themselves against the distortion of taxable income caused by continuing inflation concentrated on the valuation of their inventory. An attempt to use he last-in-first-out (LIFO) method for determining inventory cost for tax purposes was judicially rejected some years ago;[20] and periodic suggestions since then that the law be amended to permit the use of LIFO have not borne fruit.[21]

Taxpayers have been permitted, by the Act and the Regulations, to value their inventory for tax purposes entirely at cost, entirely at market, or at the lower of cost and market. The method of valuation used for a taxpayer's closing inventory in any taxation year must also be used for his opening inventory in the next year.[22] It had been generally thought that a taxpayer remained free to change to another permitted method in valuing his closing inventory in any year, but the Department has recently taken the position that any such change is only permissible when it can be justified by reference to GAAP.[23] This Departmental position will probably be challenged in the courts.[24]

In 1977 the government responded to requests for relief from the effects of inflation by permitting an arbitrary 3% deduction applied to the tax value of a taxpayer's opening inventory of goods that are held for sale or to be incorporated into goods to be sold or to package these goods.[25] While this relief was welcome to taxpayers who could qualify for the deduction, it was not a meaningful solution to the inflation problem.[26] This rule undoubtedly is influencing some new businesses to choose their year end at a time when inventories are high, even though this may be undesirable from a business point of view.[27]

The Department will permit the cost of inventories of work in progress and finished goods to be determined by "direct costing" (excluding fixed overhead) or by "absorption costing" (including fixed overhead); "prime costing" (excluding all overhead) will not be accepted. The Department will accept a determination of the fair market value of inventory based on either replacement cost or net realizable value, if the method is followed consistently. It says that the method used to determine both cost and market for tax purposes must correspond to the method used in the taxpayer's financial statements; here, as elsewhere on timing questions, no statutory or case authority is cited to support the Department's position.[28]

For some years it had been accepted that, to reconcile accounting income with tax income, accounting depreciation would need to be added to accounting income, because the depreciation was not deductible for tax purposes.[29] Then the appropriate amount of capital cost allowance would be deducted, and, of course, any other applicable adjustments would be made. Eventually some taxpayers realized that the Act did not require them to add back to their accounting income for a year any portion of the accounting depreciation expense for that year that was included in the cost of closing inventory, since it would not be deducted in computing the taxpayer's income for tax purposes if it was left in closing inventory. The Department became alarmed by the amount of potential tax reduction that would occur if many taxpayers switched from adding back all depreciation to adding back only the part not included in closing inventory. Consequently, by recent amendment, any such amount in closing inventory must now be added back to income for tax purposes, and the same amount is deducted in computing tax income for the following year, when it would relate to opening inventory.[30]

5. ACCOUNTING FOR INFLATION

Monetary inflation has been a problem for Canadian accountants for many years and has accelerated in recent years. During 1981 prices will have increased in Canada at an annual rate of over 12%. Not surprisingly, the in-

18. *Sinnott News Co. Ltd.* v. *M.N.R.*, [1956] C.T.C. 81, 56 DTC 1047 (Supreme Court of Canada); *Harlequin Enterprises Ltd.* v. *The Queen*, [1977] C.T.C. 208, 77 DTC 5164 (Federal Court of Appeal).
19. *The Queen* v. *Esskay Farms Ltd.*, [1976] C.T.C. 24, 76 DTC 6010 (Federal Court, Trial Division).
20. *M.N.R.* v. *Anaconda American Brass Ltd.*, [1955] C.T.C. 311, 55 DTC 1220 (Judicial Committee of the Privy Council).
21. See Broadhurst, "Financing and Tax Incentives", in *Corporate Management Tax Conf.* 300, 301-10 (Can. Tax Foundation 1980).
22. Act, subsections 10(1), (2); Regs., section 1801.
23. Interpretation Bulletin IT-473, para. 4 (17 March 1981).
24. Consistency of accounting treatment was required in *The Queen* v. *Wilchar Construction Ltd.*, [1979] C.T.C. 117, 79 DTC 5086 (Federal Court, Trial Division), where a change of method would permit some income to escape tax. See also Act, subsections 10(3)-(5).
25. Act, paragraph 20(1)(gg).
26. See Report of the Ontario Committee on Inflation Accounting 64-67, note 13.
27. Some loopholes in the original rules were blocked by the addition to the Act of subsections 20(17), (18).
28. See Interpretation Bulletin IT-473, paras. 8, 12, 16 (17 March 1981).
29. Act, paragraph 18(1)(b).
30. Act, paragraphs 12(1)(r), 20(1)(ii).

come tax system, which uses only historical costs to measure expenses, has been criticized for imposing taxes on inflated profits. The existing indexing of "personal exemptions" and rate brackets for individuals does not remedy the overstatement of business income or capital gains for tax purposes. As mentioned earlier, generous rates of capital cost allowance and the 3% inventory allowance may offer some relief; but any such relief is arbitrary, is discriminatory among different classes of taxpayers, and in the great majority of cases is patently inadequate.

Understandably, the government regards requests for relief from the effects of inflation on the measurement of business income as involving threats to its revenues. Consequently it has not resisted the temptation of sheltering behind the accounting profession's failure to agree on a method of resolving the inflation problem for accounting purposes. In effect the government has said that once an appropriate method of accounting for inflation has become generally accepted, the possible adoption of that method for tax accounting can be seriously considered.

The Canadian Institute of Chartered Accountants has given careful consideration to the implications of adopting either price indexing or current cost accounting to resolve the problem of inflation accounting.[31] It now appears to be ready to recommend current cost accounting – initially as a supplement to financial statements prepared in accordance with traditional historical cost accounting. Obviously any such hesitant development offers little hope for a speedy resolution of the problem of tax accounting for inflation.

One thoughtful commentator has questioned the appropriateness of the government's "wait and see" position on addressing the inflation problem for tax purposes. According to G.E. Cronkwright,[32] a prominent Canadian tax accountant, current cost accounting would never be suitable to be used to measure income for tax purposes: the calculations and assumptions involved, in his view, are too subjective. Attempts should therefore proceed to resolve the inflation problem for tax purposes without waiting for a resolution of the problem for accounting purposes, since the solutions are likely to be different. This conclusion seems valid; but any resolution of the tax problem, unless it is to be totally arbitrary, still involves what is essentially an accounting question, which will need to be answered by skilled accountants.[33]

What seems to be required, therefore, is prompt action by the federal government to appoint a committee consisting of prominent accountants from the private sector and tax policy personnel from the Department of Finance, with a mandate to recommend a practical and equitable method of eliminating inflationary profits from the computation of taxable income. If and when such a system is implemented, a small standing committee representing both the government and the private sector should be charged with monitoring its effectiveness and with recommending any changes that appear to be required having regard, among other things, to any relevant developments in financial accounting.

In the absence of corrective provisions in the Act, Canadian businesses appear to have no direct way of insulating themselves specifically from the tax penalty that is imposed on inflationary profits. Obviously they will try to structure their operations as to minimize adverse effects from inflation – as by maximizing debt financing – and to take whatever steps are open to them to minimize or defer their income taxes. Largely because of the rate of inflation, however, debt financing has become very expensive.

The conclusion reached in 1977 by the Report of the Ontario Committee on Inflation Accounting still seems valid:

> It is clear that the impact of inflation on the taxation of business income creates major cash flow and liquidity problems. In addition, inflation also results in an unintended and automatic shift of wealth from business capital to government. To date, tax relief for the effects of inflation has been limited and largely fortuitous being based on the effect of allowances permitted for other reasons.[34]

6. REQUIRED CONFORMITY WITH FINANCIAL STATEMENTS

As indicated earlier, the Department in recent years has taken the position that, except where the Income Tax Act requires the adoption of a specific accounting method for tax purposes, a taxpayer's choice among alternative methods must conform with the choice made in his financial statements. Presumably the Department's concern is that taxpayers will choose for tax purposes, among acceptable alternatives, the method that will give them maximum tax advantage even though, by choosing another method for their financial statements, they indicate that the method adopted for tax purposes is not the most appropriate way of measuring their income.

There is no support in the Act for the Department's position, and some leading judicial decisions seem to have rejected it.[35] If that position did reflect the present state of the law, it would be open to the same objections as was the former rule, mentioned earlier, requiring the amount of capital cost allowance to be limited to the amount shown as accounting depreciation: it would force some taxpayers to pay more tax than they would otherwise have to pay, because they are unwilling or unable to report to shareholders and creditors in their financial statements in a way that minimizes their accounting income;[36] and taxpayers not so constrained would be induced to distort their financial statements in order to achieve a maximum tax advantage. As well, if the Department's

31. See Guideline on *Accounting for the Effects of Changes in the Purchasing Power of Money* (Can. Institute of Chartered Accountants 1974); Discussion Paper on *Current Value Accounting* (Can. Institute of Chartered Accountants 1976).
32. Cronkwright, "The Dilemma of Conformity: Tax and Financial Reporting – A Perspective from the Private Sector, in *Corporate Management Tax Conf.* Can. Tax Foundation 1981).
33. See also Arnold & Bonham, "The Measurement of Income: Selected Problems, in *Canadian Taxation* 543, 563-71 (B.G. Hansen, V. Krishna, & J.A. Rendall eds., De Boo 1981).
34. Loc. cit. note 13, at p. 75.
35. See, e.g., *The Queen* v. *Oxford Shopping Centres Ltd.*, note 2.
36. See Arnold, "Conformity between Financial Statements and Tax Accounting, 29 *Can. Tax J.* 476 (1981).

position is to become law, many of the same considerations that arose when it was proposed to legislate the application of GAAP for tax purposes may need to be debated again.

7. CONCLUSION

It is fortunate that, on the whole, tax accounting rules in Canada are not so artificial as to require, or make advisable, unusual or complex corporate structures. Inevitably these rules will influence business decisions, and there have been several recent statutory, judicial, and administrative developments relating to tax accounting that may affect business planning. Much of the current confusion and uncertainty can be traced to the failure of the government to invite discussion and seek a consensus on the appropriate relation between tax accounting and financial accounting. Such a dialogue might prove highly productive at this time.

CANADA:
Summary of Modifications in Draft Legislation

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Reserves

There are also modifications to proposals relating to the deduction of certain reserves on instalment sales of property where the proceeds are not received until a future year. The business reserves proposed for sales of real estate will be extended to sales of all inventory and the computation of the reserve will be based on the portion of the total proceeds that remain unpaid over a three-year period.

Foreign subsidiary loans and corporate reorganisation measures delayed

With respect to the changes proposed in Budget Resolution 14 relating to low-interest or interest-free loans by Canadian corporations to their foreign subsidiaries, and amendments affecting corporation reorganizations, Mr. MacEachen intends to further consider these particular changes. The treatment of loans to non-resident corporations is part of a broader study of the taxation of foreign source income that is currently under way. In the area of corporate reorganizations, the Minister intends to refer the amendments in this very complex area of the law to a group of outside consultants for review. Changes in these areas will not be proceeded with before the studies have been concluded and a discussion document has been made public.

Employees share purchase loans

The Minister said that the proposed restriction on deductibility of interest expense would not apply to interest under commitments prior to 12 November 1981 relating to employee share purchase loans. The decision to "grandfather" such loans recognizes that in many circumstances employees are locked into relatively long-term arrangements and are unable to reorganize their affairs. The application of the interest restriction to corporations under Budget Resolution 24 was intended as an anti-avoidance measure and the Minister confirmed that, as such, it would apply only to those private corporations that carry on either a personal service or a professional business.

RRSP loans

The draft legislation does, however, contain the proposals in Budget Resolution 20 relating to the non-deductibility of interest on loans to finance contributions to registered retirement savings plans (RRSPs) and certain other plans.

Non-resident withholding tax exemptions

The Minister also announced a three-year extension of the non-resident withholding tax exemption for interest paid on government and long-term corporate borrowings. The existing exemption is scheduled to terminate for bonds and other debt issued after 1982. The Minister indicated that the amendments necessary to provide for the extension of the exemption for interest on debt obligations issued before 1986, while not included in the draft legislation, would be reflected in the implementing legislation to be introduced in the fall.

Draft regulations defining terms

In addition, Mr. MacEachen released the text of draft regulations (attached) that describe what is to be included in the expression "prescribed share" for the purpose of paragraph 112(2.3)(g) and paragraph (f) of the definition "term preferred share" in the draft legislation. The draft regulations are essential for an understanding of these two provisions.

Communication with Department of Finance

Mr. MacEachen said that taxpayers with particular technical concerns arising out of the draft legislation should write to the Tax Policy and Legislation Branch, Department of Finance, Ottawa, K1A 0G5.

DRAFT INCOME TAX REGULATION

SCHEDULE

1. Section 6201 of the *Income Tax Regulations* is revoked and the following substituted therefor:

"6201(1) Subject to subsection (2), for the purposes of paragraph 112(2.3)(g) of the Act and paragraph (f) of the definition "term preferred share" in subsection 248(1) of the Act, a share is a prescribed share with respect to a corporation (in this subsection referred to as the "recipient") that receives a dividend at any time in respect of the share if it was acquired after 28 June 1982 and is of a class or of a series of a class of the capital stock of a corporation that is listed on a stock exchange referred to in section 3200 unless in the aggregate dividends are received at that time from the corporation in respect of more than 10% of its issued and outstanding shares of that class or of that series, as the case may be, by
(a) the recipient, or
(b) the recipient and persons with whom the recipient does not deal at arm's length.

(2) For the purposes of paragraph 112(2.3)(g) of the Act and paragraph (f) of the definition "term preferred share" in subsection 248(1) of the Act, a share is hereby prescribed that is a share last acquired before 29 June 1982 and is of a class or of a series of a class of the capital stock of a corporation that is listed on a stock exchange referred to in section 3200 unless in the aggregate more than 10% of the issued and outstanding shares of that series or of that class, as the case may be, are owned by
(a) the owner thereof, or
(b) the owner and persons related to him."

2. Section 1 is effective on and after 13 November 1981.

The Long Reach of the United States in Tax Matters

by Piroska E. Soos*

In *United States v. Quigg,*[1] the United States District Court for the District of Vermont ordered a Canadian bank to produce certain records which were located at the bank's branch in the Bahamas and which related to accounts held by a U.S. citizen who was being criminally prosecuted on charges of federal income tax evasion. The District Court's decision was recently affirmed by the U.S. Court of Appeals for the Second Circuit.[2]

The case involved a U.S. taxpayer (hereinafter "T") as well as the Canadian Imperial Bank of Commerce (hereinafter "Bank"), a large bank based in Toronto with approximately 1,700 branches and agencies throughout the world, including the U.S. and the Bahama's. On 21 November 1980, in response to an application by the U.S. Government (hereinafter "Government"), the District Court (hereinafter "Court") issued a trial subpoena ordering the Bank to produce records of any account maintained by T at the Bank since 1972. The subpoena was addressed to "any authorized officer" at the Bank's agency in New York City and was served on an assistant accountant at the New York agency. Although the subpoena sought the production of records at any of the Bank's branches or agencies, the Government indicated that the subpoena was limited to a search of the records at the Nassau branch in the Bahamas.

The Bank objected to the subpoena on two grounds: (i) pursuant to cases decided by the U.S. Court of Appeals for the Second Circuit,[3] the Bank could not be compelled to produce bank records if production would subject it to criminal liability under the banking laws of the Bahamas, and (ii) service of the subpoena on the New York agency did not give the Court jurisdiction over the Bank's headquarters and branches located outside the U.S., and the New York agency could not produce the records because they were beyond its control. For the reasons stated below, the Court rejected both objections.

CRIMINAL VIOLATION OF BAHAMIAN LAW

In considering the Bank's first objection, the Court noted that, under Bahamian law, it was a crime for any officer or employee of a bank or trust company to disclose "information relating to the identity, assets, liabilities, transactions, (and) accounts of a customer" without the customer's consent, except under certain circumstances not relevant in this case.[4] Relying on principles of comity and international law, the Court refused to compel the Bank to disclose anything that would subject it or its employees to criminal liability. Enforcement of the subpoena, therefore, depended on T's consent to the disclosures.

T stated that he would not voluntarily consent to the release of the Bank's records and, thereupon, the Government requested the Court to order T to execute a consent form permitting the Bank to release the records. The Court granted the Government's request and, in so doing, rejected T's arguments that requiring T to consent would violate his rights under the due process and self-incrimination clauses of the Fifth Amendment to the U.S. Constitution.

The relevant part of the Fifth Amendment provides that

> . . . nor shall any person be subject for the same offense to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property without due process of law; nor shall private property be taken for public use without just compensation.

The Court generally agreed with T that the due process clause means that a criminal defendant is not obliged to cooperate with the Government in his own prosecution. However, the Court pointed out that T had not considered some important exceptions to the general rule. For example, a criminal defendant may be required to submit to a blood test, to participate in an identification line-up, to produce a handwriting sample, or to produce papers in his possession which may be damaging at trial but which fall outside the protection of the Fifth Amendment.

The Court relied on *Fisher v. U.S.*[5] in which the U.S. Supreme Court said that an individual under investigation for tax violations could not refuse to produce papers in his possession which were prepared by an accountant and thus beyond the scope of the Fifth Amendment. The Court concluded that, unless the privilege against self-incrimination or another constitutional right applies, a criminal defendant may be ordered to produce evidence in his possession or to cooperate in other ways.

The privilege against self-incrimination did not apply in this case since the records involved were not the kind (private or testimonial) protected by the Fifth Amendment. The Court cited two U.S. Supreme Court cases[6]

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1. — F. Supp. — (D. Vt., 5 January 1981); 48 AFTR 2d 81-5953.
2. Affirmed by an unpublished order dated 30 November 1981.
3. *Ings. v. Ferguson,* 282 F.2d 149 (2d Cir. 1960); *Application of Chase Manhattan Bank,* 297 F.2d 611 (2d Cir. 1962); *Trade Development Bank v. Continental Insurance Co.,* 469 F.2d 35 (2d Cir. 1972).
4. The Court cited the Bahamian Banks and Trust Companies Regulations (Amendment) Act, 1980. Section 101(1)(iii) of that Act states that one of the exceptions to the secrecy requirement concerns disclosures of records required by any court of competent jurisdiction within the Bahamas. The Court noted that, although the records sought by the Government could probably be obtained by requesting the courts of the Bahamas for an order authorizing release of the records, this procedure was not realistically available in this case since it was a time-consuming procedure and T's trial was scheduled to start in one week.
5. 425 U.S. 391 (1976); 37 AFTR 2d 76-1244.
6. *California Bankers Asso. v. Shultz,* 416 U.S. 21 (1974); 33 AFTR 2d 74-1041, and *U.S. v. Miller,* 425 U.S. 435 (1976); 37 AFTR 2d 76-1261.

for the proposition that, for purposes of the Constitution, bank records are records maintained by a third party (the bank) and are neither private nor testimonial. The banking laws of the Bahamas did not alter this rule. In *U.S. v. Payner,*[7] the U.S. Supreme Court considered the bank secrecy laws of the Bahamas and concluded that the laws create no special expectation of privacy which is not present under American banking laws. Thus, the Fifth Amendment did not bar production of the records. The Court noted that, under the rule in *Fisher v. U.S.*, the records could be subpoenaed directly from T if they were in his possession. Ordering T to remove an obstacle created by Bahamian law was in effect no different from subpoenaing the records from T.

Finally the Court rejected T's argument that the act of executing the consent form was a testimonial act which is protected by the privilege against self-incrimination. In the Court's view, the consent merely permitted the Bank to release any records it might find, and the consent did not mean that T admitted ownership of an account in the Bahamas or vouched for the accuracy of the records.

JURISDICTION OF U.S. COURTS OVER RECORDS LOCATED ABROAD

The jurisdictional question related to the Court's subpoena power over the Bank's branches outside the U.S. The Government's position was that service of the subpoena on the Bank's New York agency subjects the Bank's headquarters and all the branches to the subpoena power of the Court.

The Court stated that the subpoena power of the Court in criminal matters is not explicitly conferred by statute but derives from the U.S. law which grants jurisdiction over offenses against the U.S. to the federal courts. The grant of subject matter jurisdiction (i.e. over the offense) necessarily carries with it an implied grant of the subpoena power subject, however, to certain restrictions not applicable here.

The geographic reach of power may be inferred from the Federal Rules of Criminal Procedure. Rule 17(e)(2) relates to service on a witness in a foreign country who is a national or resident of the U.S. This provision did not apply to the Bank since it was not a U.S. resident. Rule 17(e)(1), however, provides for service of a subpoena on anyone *found in* the U.S., and for this purpose, a foreign corporation may be found in the U.S. even though its headquarters and place of incorporation are in a foreign country.

The Court said that the Bank would be considered to be "in" the U.S. if it were "doing business" there. The Court examined the affidavits of the Bank's representatives and concluded that the Bank, through its New York agency, carried on activities in the U.S. on a scale sufficient to constitute "doing business".[8] Since the subpoena power over a foreign corporation doing business in the U.S. extends beyond the corporation's operations in the U.S., the Bank's records in the Bahamas could be reached by the Court.

The Court was not willing to go so far as to say that a foreign corporation might be obliged to open all its files to American courts and prosecutors merely because it opens an office in the U.S., but the Court did not say where it would draw the line. The Court noted, however, that, in this case, the subpoena was directed only at the bank records concerning a U.S. citizen who was under indictment for violations of U.S. tax laws. The subpoena, therefore, represented no great intrusion into the purely foreign affairs and operations of the Bank and its customers. In addition, the Bank should not be surprised that the Government is interested in the foreign bank accounts of its citizens. The Bank chose to enter the U.S. to conduct business and, by that act it became obliged to respond to reasonable requests for information concerning its transactions with Americans both in the U.S. and abroad.

COMMENTS

In *Quigg,* the Court stated unequivocally that it was unwilling to compel any disclosures that would subject the Bank or its employees to criminal liability in the Bahamas. This statement may be compared to an opinion rendered by the U.S. Court of Appeals for the Ninth Circuit in which the Ninth Circuit was less sympathetic to the taxpayer's plight that compliance with a summons would violate Swiss law.[9] In that case, the U.S. Internal Revenue Service sought production of certain records of a U.S. corporation and its foreign subsidiaries. Some of the records were in Switzerland, and one of the grounds on which the taxpayer objected was that production of the Swiss records would violate Swiss law that makes it a crime to disclose business secrets. The Ninth Circuit rejected the objection because the taxpayer had not shown a substantial likelihood of a successful prosecution in Switzerland. The Ninth Circuit also noted that the taxpayer would not be in this predicament had it complied with U.S. law which requires it to keep certain records pertaining to its foreign subsidiaries.

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7. 48 *United States Law Week* 4829 (23 June 1980); 46 AFTR 2d 80-5174.
8. The Court noted that the Bank's objection was analogous to the affirmative defense of lack of personal jurisdiction which a defendant must raise and prove. The Bank had failed to meet its burden of proof as there was nothing before the Court which indicated that the Bank was not doing business in the U.S.
9. *United States v. Vetco, Inc. et al.*, 81-1 U.S.T.C. Para. 9428 (9th Cir. 1981); *certiorari denied* by the U.S. Supreme Court on 24 August 1981. For a discussion of this case, see 21 *European Taxation* 12 (1981) at 402.

BRAZIL:

The Supplementary Income Tax on the Remittance of Dividends Abroad — Legal Nature and Computation

by Ives Gandra da Silva Martins*

I. BRIEF INTRODUCTION TO THE BRAZILIAN TAX SYSTEM

The Brazilian taxation system, dealt with in the Federal Constitution under that heading, encompasses 5 different categories of taxation, namely, "taxes", "duties", "contributions", "special contributions", and "compulsory taxes".

Of course, the most significant of these are the taxes. The Federal Constitution sets forth the competence for the introduction of taxes in the following manner: 9 different taxes may be imposed by the Federal Union (Art. 21), 2 by State Governments (Art. 23), and 2 by municipalities (Art. 24). There is a narrow definition of each tax, and new taxes may be introduced exclusively through the residual competence of the Union (Art. 18 §5), provided that their computation basis and generating facts are different from those of existing taxes.

The imposition of the tax on income and gains of any nature is exclusively the prerogative of the Federal Union (Art. 21, item IV of the Federal Constitution). Art. 43 of the National Taxation Code delimits the scope of this tax. It reads as follows:

> The tax on income and gains of any nature is under the competence of the Union, and its generating facts are the acquisition of economic or juridical availability:
> I – of income, such as the proceeds of capital, of work, or of a combination of both;
> II– of gains of any nature, such as property increases not included in previous items.

The tax on income and gains of any nature is governed by Federal legislation of a varied nature, under which 3 different tax regimes exist, i.e. for individuals, for legal entities, and taxation by withholding.

A fourth regime can be mentioned, resulting from the 13 double tax treaties whereby Brazil, adjusting its tax system to the systems of other countries, has many times adjusted its internal system to adapt itself to systems of other countries under which the place where the service was rendered is considered as the generating fact of taxation and not the place of the source of payment. Such treaties have been concluded with: Austria, Belgium, Denmark, Finland, France, Germany, Italy, Japan, Luxembourg, Norway, Portugal, Spain and Sweden.

On the other hand, Brazil adopts generally a progressive rate system for the income of individuals, and a fixed rate for most legal entities. The rates of individual income tax range from 3 to 55%, and corporate income tax has a fixed rate of 35%, except for the few cases in which an additional 5% on taxable profits in excess of Cr $ 86,000,000 is levied (base year 1981, fiscal year 1982).

In addition to income tax on the profits of legal entities, there is an income tax on the distribution of dividends, ranging from 15 to 25%, in the form of a withholding tax for both individuals and legal entities.

When dividends are remitted abroad the rate of the withholding tax is 25% (except for reduced rates in double taxation treaties), provided that they do not exceed the limit of 12% per year (computed over a 3-year period), in which case the tax is considerably increased by the supplementary income tax ranging between 40 and 60%. Arts. 544 and 555 of item I of the Income Tax Regulation read as follows:

> Art. 544
> Dividends, cash bonuses, profits, and other interest, except for those referred to in items I, III, and IV of Art. 37 and those referred to in the introduction to Art. 547, are subject to withholding tax at the rate of:
> I –15% when distributed to individuals residing or domiciled in the country by open capital corporations and by service companies relative to the exercise of a duly regulated profession;
> II –25% when distributed to individuals residing or domiciled in the country by the remaining types of legal entities;
> III– 15% when distributed by legal entities to other legal entities with head office in the country.
>
> Art. 555
> The following are subject to withholding tax:
> I –at a 25% rate, income received by individuals or legal entities referred to in the previous article, gains derived from short term operations included, as well as capital gains relative to investments in foreign currency, except for those referred to in items II and III (Law 3470/58, Art. 77, Decree-Law 1401/75, Art. 4); . . .

Our intention is to analyze the philosophy behind the supplementary income tax in view of the wide discrepancies of interpretation in Brazilian taxation circles. In order to provide the reader of the *Bulletin* with a clear view of such discrepancies, we first present our position and then Federal Revenue Ruling No. 77/78, which briefly presents the interpretation of the Federal Treasury.

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II. INTRODUCTION TO THE STUDY

Tax law is based on principles, norms, and institutions similar to those of other legal disciplines, but it is an autonomous part of Brazilian legislation. However, it has an important impact on other branches of knowledge such as economics, public finance, politics, sociology, and even ethics.[1]

There may perhaps be no other branch of law with such varied connections, which is reflected by its capacity of touching the very essence of the science it influences.

Poor formulation of taxation policy and subsequent application of inadequate laws has been a major factor altering history, examples being offered by the out-break of the American Revolution or by the Brazilian "Inconfidência Mineira".[2] Likewise, it is common knowledge that taxes are used to treat severe economic illnesses, namely, inflation, recession and underdevelopment. In addition, the socialist societies have their foremost trend indicator in the formulation of the taxation policy, and, in some countries, taxes are sometimes used to re-orient mores and preserve moral values.

Formally, a country's budget is, in practice, prepared on the basis of the forecast of tax revenues, the tax being the most relevant among the 5 classic public revenues.[3]

Taxation, therefore, is an essential and unique feature of Budget Law, far more so than its principles which, although pertaining to this area of law, are similar to principles of other areas of the law, for instance, *the principle of strict legality, the principle of characterization and the principle of the provision in law,* the latter also being peculiar to criminal law.

Taxes have such an important function, in any of their categories,[4] that they are always created by the legislator for a special purpose so that the essence of their creation rests on their teleological aspect. Taxes may have a wide range of objectives which determine the essence of their legal nature.

Among the most important intentions of the legislature are those which result in a tax being both a penalty and a guideline for economic policy, as may be seen in the case of the urban property tax: the City of São Paulo increased this tax to 200% on illegal buildings. In such a case, the penalty is incorporated into the very structure of the tax, serving as a strong disincentive to concealed operation and as a factor re-orienting municipal policy, and aiming at harmonious and planned urban development.[5]

It is in such light that one should carry out a preliminary study for purposes of discussing the supplementary income tax, i.e. taking into account this important aspect of the Brazilian legislation, which accepts that taxation is used to reach certain goals.[6]

Article 3 of the National Taxation Code defines the concept of tax:

> A tax is any mandatory money payment, in currency, or whose value may be expressed in currency, which is not punishment of an illegal act, provided by law and collected by administrative authorities vested with their lawful power.

This definition is accepted by the vast majority of Brazilian legal commentators[7] as having general validity.

This concept is supplemented by Article 113, which provides:

> Tax liability is either primary or accessory.
> § 1– Primary liability is brought about by the occurrence of the generating factor, its object is represented by the payment of the tax or fine, and is terminated together with the claim it entails.
> § 2– Accessory liability is a result of taxation legislation and its object is represented by positive or negative measures provided therein in the interest of tax collection or auditing.
> § 3– When not observed, the accessory liability becomes primary liability as regards the fine.

Two conclusions may be immediately arrived at: the Code explicitly defines the concept of tax and implicitly defines the concept of penalty, as the latter, although a punishment for an illegal act, has the same nature as a tax; and, secondly, that the above article places tax and penalty in the same category.

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1. In the Second Latin American Regional Symposium of Taxation Law, Edvaldo Brito stressed such interaction in his paper "Social and Economic Contributions: Legal Nature and Prescription" *(Resenha Tributária,* 1976).
2. In our lecture opening the First Brazilian Congress on Revenue-Taxpayer, organized by the Federal Revenue, entitled "Taxes: Social Justice and Development" *(Revista Projeção,* pp. 68-71, December 1979), we said: "When we were invited to open the academic session of the Interamerican Association of Taxation dedicated to Interamerican Taxation Coding, in Rosário, Argentina, in 1976, we were surprised at the excellent studies prepared by the then dean of Rosário University, Prof. Manuel de Juano, current chairman of the Fiscal Commission of the Interamerican Bar Association. Prof. de Juano, when he organized the first Taxation Law Museum of the world, showed that there has never been a revolution or insurrection in the history of mankind that did not have an incorrect application of taxation policy at its roots. Such incorrect application generated tensions which directly led to the non-acceptance of the directions desired and led to upheavals, such as the "derrama" in the Brazilian episode of the "Inconfidência Mineira", or in the Townshend Law, imposing import duties on glass, lead, paper, paints and tea, by the time America was fighting for independence, starting in 1767."
3. Aliomar Baleeiro stresses this aspect in his well-known *Introduction to Financial Science* (*Forense* - several issues).
4. Authors do not agree as to the number of categories of tax. Geraldo Ataliba only distinguishes between taxes levied for a specific purpose and general taxes ("Em prol da contribuição de melhoria", *Resenha Tributária,* 1976); Paulo de Barros Carvalho discusses two categories: taxes and duties ("Comentários ao Código Tributário Nacional - Artigo 16°", *Revista dos Tribunais,* c/ Geraldo Ataliba and Rubens Gomes de Sousa); most authors tend to distinguish between 3 categories: taxes, duties, and special contributions – Ruy Barbosa Nogueira ("Curso de Direito Tributário", Saraiva), Fábio Leopoldo de Oliveira ("Curso Expositivo de Direito Tributário", *Resenha Tributária)* among others; Aires Fernandino and Manuel de Juano list 4 categories divided into 2 sectors: first, "improvement contributions" and "special contributions", excluding, however, the compulsory loan *(Caderno de Pesquisas Tributárias* 2), and, second, distinguishing the "improvement contribution" from the "special ones" *(Manual de Finanzas e Derecho Tributário,* Molachino); Ives Gandra da Silva Martins ("As Contribuições Especiais numa Divisão Quinquipartida dos Tributos", *Resenha Tributária),* Fábio Nusdeo *(Comentário ao CTN,* vol. 3, José Bushatsky) and Bernardo Ribeiro de Moraes *(Caderno de Pesquisas Tributárias* 2, *Resenha Tributária)* defend the existence of 5 categories (taxes, duties, special contributions, improvement contributions, and compulsory loans).
5. The Second Interamerican Congress of Taxation Law was specially dedicated to the theme "Determination of guidelines for a taxation policy for urban development" (papers published by *Resenha Tributária,* 1975).
6. See H.L.A. Hart: *The Concept of Law* (Clarendon Law series).
7. Geraldo Ataliba and Souto Maior Borges, in "Sistema Constitucional Tributário", in "1° Ciclo de Conferência sobre Temas Tributários" and "Lei Complementar" *(Resenha Tributária* and *Revista dos Tribunais,* respectively), do not totally accept it, and represent isolated positions which conflict with those of Gilberto de Ulhao Canto, Rubens Gomes de Sousa, Aliomar Baleeiro and Carlos de Rocha Guimarães, the drafters of the Brazilian tax system.

On the other hand, such a legal frame leads to the existence of 2 special forms of tax assessment in the Brazilian legislation: "punitive taxation" and "discouraging taxation", with closely related areas of application, the former encompassing all characteristics of the latter, but the latter not always encompassing those of the former.[8] The taxes levied on disguised profit distributions (individual and corporate taxes are solely borne by individual taxpayers) or for the property tax mentioned above, with the objective of penalizing and discouraging, are considered "punitive taxation". An example from French legislation of simple "discouraging taxation" is the tax on real estate concentration, the aim of which is to reduce urban verticalization, although some commentators say that discouraging is a means of penalizing those activities which are supposedly legal, but in essence illegal.[9]

It is a fact that punitive or discouraging taxation, within the scope of defined objectives, occurs more in view of its extra-fiscal function than for its function of generating funds for public services.[10]

From the above concept one understands that the Brazilian legislature wished to liken their legal natures even when it stressed their differing elements (whether or not they should be considered a punishment), treating them as species belonging to the broader category of taxes in general. Tax liability is considered to become effective upon the occurrence of a generating fact, and it is transformed into a taxation claim upon the assessment. With respect to discouraging and punitive taxes, as well as taxation punishments, legal interpretation may not admit any principles other than those of strict legality, characterization, and of the provision in law as the only manner to avoid arbitrariness of interpretation.[11]

Such principles are applied to the entire tax system, for they are inherent to a system under which the taxpayer has only the law as his guarantee. As he cannot take part in the formulation of law, which is always imposed on him under the legal power of authorized Revenue agents, the only guarantee that nothing will be required from him in addition to what the law provides lies solely in the 3 mentioned principles.[12]

That is why legal theory and the courts do not grant any room to the administration to issue regulations with respect to the norm provided in the law, because the power of regulating is often confused with the power of demanding, and such integration in the person of the Revenue agent may lead to an interpretation to the benefit of the Revenue and thus always unfavorable to the weakest party, i.e. the taxpayer or the assignee.[13]

Thus, when the Constitution states that only the law creates tax liabilities, and the National Taxation Code provides that only the law may introduce an increase in taxes, the principles to safeguard the rights of the taxpayer or the assignee were obviously included in the legislation. Thus the drafters of the Constitution and the supplementary legislation adopted the 3 principles mentioned above, which prevent the analogical interpretation as to tax laws or the use of a "benigna amplianda" (extensive) interpretation and, in cases of doubt, the law must be interpreted in favor of the taxpayer.[14]

As this is the essence of the Brazilian tax system, under the principle of strict legality, only what is provided in the law may be demanded. As a result, taxation law encompasses the principle of provision in the law, meaning that under no circumstances is the legislative competence delegated to the Revenue agent nor permission given to use such extensive interpretation by such agent. This principle is absolute and not merely formal.

As a last corollary, the type of the tax is "closed", i.e. may not be extended, and must be fully described in the law due to 4 additional sub-principles: (i) the principle of exclusiveness, stating that such tax is exclusive and may not be mistaken for other types of tax; (ii) the principle of selection, according to which the law indicates the tax; (iii) the principle of determination, which after the selection of the tax delimits its scope in an accurate and objective manner; and (iv) the "numerus clausus" principle, which limits the number of taxes and prevents any addition not provided for in the law to this type of tax.[15]

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8. *Caderno de Pesquisas Tributárias* 4, dedicated to the theme "Taxation Penalties" *(Resenha Tributária,* 1979) containing studies by 13 well known Brazilian and Argentine authors, in addition to the drafter of the ruling, studies several aspects of these two types of fiscal assessment.

9. In France, the higher taxes on luxury hotels and X-rated films (even when they are considered art films) intend to reach those grey areas, where the illegal dwells in a certain atmosphere of legality.

10. See Fábio Fanucchi, "A Tributação Penal", *Revista de Direito Público* 25, pp. 105-119.

11. Aires Fernandino Barreto prefers to call the first of them the "principle of absolute provision in formal law" ("Princípio de Legalidade e Mapas de Valores", in *Caderno de Pesquisas Tributárias* 6 of the Centro de Estudos de Extensão Universitária and *Resenha Tributária* - 1981, dedicated to the theme "Principle of Legality").

12. Yonne Dolácio de Oliveira, in her book *A Tipicidade no Direito Tributário Brasileiro* (Saraiva, 1980), states: "As the legal relation between the Revenue service and the taxpayer is established by law, creating a legal obligation for the legal subjects, the normative structural characterization limits the will of the parties, of the legislature and of the enforcer. This causes a great tension originating in the two values, "sureness" and "safety", calling for a closed type of law. These two values are different but imply each other: *sureness provides for a situation in which the scope of the law will not be extended; safety guarantees that only that which is the object of a legal definition shall be required"* (p. 180; our emphasis).

13. Gerd. W. Rothmann reaches the same conclusions in his study "O Princípio de Legalidade Tributária" in *Direito Tributário* - 5º Coletânea (Bushatsky, 1973), p. 154.

14. Art. 153 § 2 of the Federal Constitution, Art. 97 items I and II, Art. 108 § 1 and Art. 112 of the National Taxation Code read as follows:

"Art. 153 – The Constitution assures all Brazilians and foreigners residing in the country the inviolability of the rights related to life, freedom, safety, and property, on the following terms: . . .

§ 2. No person shall be obliged to do or not to do anything if not under the law."

"Art. 97 – Solely the law may determine:

I. the institution of taxes, or their termination;

II. the increase of taxes, their reduction, provisions of Arts. 21, 26, 39, 57 and 65 being observed . . ."

"Art. 108 – In the absence of express provision, competent authority, when enforcing taxation legislation, shall successively resort to, in the order indicated:

I– analogy;

II– general principles of taxation law;

III– general principles of public law;

IV– equitableness.

§ 1. The use of analogy may not result in the demand of a tax not provided for in the law".

"Art. 112 – Taxation law defining infringements, or attributing penalties to such infringements, shall be interpreted in a favorable manner to the defendant whenever there is doubt as to:

I– the legal classification of the fact;

II– the nature or material circumstances of the fact, or the nature or extension of their effects;

III– the nature of the applicable penalty or its grading."

15. P. 337 of *Caderno de Pesquisas Tributárias* 6 *(Resenha Tributária e Centro de Estudos de Extensão Universitária)* reads as follows: "It so happens that in the area of taxation law, the principle of legality, through the definitive pro-

In sum there are the guidelines orienting the national taxation law, particularly in the areas of taxation punishments, punitive taxation, and discouraging taxation.[16]

III. SUPPLEMENTARY INCOME TAX – LEGAL NATURE

We will now try to see where the supplementary income tax fits in view of its legal nature.

Two questions immediately arise. The first one is to know whether or not such tax would fit in the category of discouraging taxation. The second is whether it would have the same legal nature as the regular withholding tax.

As to the first question, the answer seems simple.

When the law regulating the legal nature of foreign investments in Brazil (Law 4,131/62) was created, Art. 44 introduced the concept of the supplementary income tax, thus increasing the regular tax by an additional 20% for those foreign corporations of little national interest. The objective was to ensure the right of remittance of dividends, but, simultaneously, to show that their presence in Brazil was considered of little significance to that country, since they could be taken over by national capital. The 2 objectives laid down in Art. 44 in 1962 were: (1) the policy of discouraging the presence of foreign capital in Brazil and the remittance of profits, and, (2) encouraging the re-investment of profits within the country.[17]

In 1964, the legislation with respect to supplementary income tax was amended and the introduction of its current form made the governmental intention more clear. The present policy is to attract foreign capital, to stimulate its permanence and to reinvest the results in Brazil, and to discourage excessive remittances through the adoption of considerably higher and progressive tax rates.

Brazil is a country clearly lacking capital for development, and in need of both such capital and more developed technology from industrialized countries. Therefore, in 1964, the government tried to apply a formula with sufficient flexibility to attract capital from industrialized countries, allowing its repatriation and, at the same time, clearly discouraging the non-reinvestment of results in excess of certain limits, reflecting the average profitability figures of national companies.[18]

Therefore, the aim of the supplementary income tax was to discourage the taxpayer to remit too much profit abroad and to keep part of his profits in the country.[19]

Therefore, this is a type of tax which, even more than other taxes, is subject to interpretation under the foregoing principles, because the taxpayer who legally exercises his right to remit dividends abroad in excess of the limits set by the law will be subject to a higher tax.

There is no doubt that this concept fits within the category of discouraging tax mentioned above, so that the pertinent law may only be interpreted within strict limits, and the Revenue agent is not permitted to create, innovate, amend, change, or include any fact or norm which is not expressly foreseen by the law.

The second aspect concerns its legal nature. Does the supplementary income tax have the same legal nature as the withholding tax or does it have a different nature?

Although *Alberto Xavier* tends to find a different nature in this tax, and presents it in his brilliant and talented way, we do not agree with him.[20]

The famous author concludes that the characteristics of collection of the regular tax are different from those of the supplementary tax, first of all in view of the 3-year computation period, then in view of the factor reducing the percentage from one 3-year period to the next, related to those years in which remittance was above 12%, and, finally, in view of the factors related to the manner of computation.

We do not believe that this conclusion can be accepted, as all of the different characteristics refer to the mere collection technique and not to the structure and essence of the tax.[21]

The withholding tax assessed on remittances of up to 12% of capital or in excess of this amount has the same

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vision in law, allows for the necessary characterization, which determines the tax obligation as well as its factors, namely: the exact quantification of the rate, of the computation basis, or of the penalty. To conclude, it becomes evident that the logical consequence of the application of the principle of selection, the taxation norm determines the type of tax or penalty; according to the "numerus clausus" principle, it voids the use of analogy; according to the principle of exclusiveness, it renders the factual situation different from any other, although the situations may resemble each other very closely; and, finally, according to the principle of determination, it states the event to be taxed in a clear and objective fashion, whereby the use of elastic norms is absolutely forbidden."

16. Alberto Xavier, in his small but brilliant book *Os Princípios da Legalidade e da Tipicidade da Tributação* (Revista dos Tribunais, 1978), states: "And it follows that the norms which institute must necessarily be material decision norms (Sachentscheidungsnormen), according to the work of Werner Flume, because, contrary to what happens to action norms (Handlungsnormen), *these are not limited to authorizing the enforcement agency to exercise power in a relatively free manner, they rather impose a concrete decision criterion, thus predetermining its behavior"* (emphasis added).

17. Art. 44 reads as follows:
"Said tax shall be collected with an added 20% in the case of companies engaged in economic activities of lesser interest to the national economy, considering its localization, as defined in a decree of the Executive Power and in view of a hearing of the National Economy Council and the Council for the Superintendence of Currency and Credit."

18. It is interesting to recall that a stricter formula was adopted under the revolutionary regime, whose politics were aimed at maintaining a market economy. See Roberto de Oliveira Campos and Mário Henrique Simonsen, *A Nova Economia do Brasil* (Livraria José Olympio Editora, 1974).

19. Law 4,390 dated 29 August, 1964.

20. In his "Direito Tributário Internacional do Brasil", p. 204, he says: "With the purpose of determining their legal nature, we tried to understand the basic characteristics of this tax distinguishing 4 different traits: (i) it is a withholding tax; (ii) it is a special tax; (iii) it has the nature of a surtax; (iv) it has an extra-fiscal nature, the center of gravity of our viewpoint lying in the extra-fiscal aspect of the tax (which, for scientific coherence, we would rather call a "discouraging tax", because this extra-fiscal nature is a fiscal nature for it takes a fiscal character and has a specific final purpose as any other tax). This, however, is not part of its legal nature, it is merely explanatory and marginal to its essence.".

21. On the occasion of the Third National Symposium of Taxation Law at the Centro de Estudos de Extensão Universitária, about the collection technique, the Plenary concluded that:
"No, the added value is not an element of the theory underlying the imposition of the ICM tax. The constitutional principle of non-cumulation consists solely of deducting the amounts payable in previous operations from the tax payable, not considering the existence of an added value" *(Caderno de Pesquisas Tributárias 4, Resenha Tributária,* p. 642), for one cannot equate a mere collection technique with the essence of the theory for the imposition of any tax.

legal nature, only the rates differ. However, the taxes are assessed as a *withholding tax and on remitted values*. That is to say that both taxes have the same purpose aiming at imposing tax on profit remittances; only a higher rate is applied in the case of the supplementary tax. In the same token, there is a higher tax on the disguised distribution of profits, but this does not alter the legal nature of the income tax on distributed profits.

The difference lies in the field of collection, just like the collection technique in the cases of deferred ICM tax in relation to assessment immediately following the generating fact with no resulting change of the legal nature.[22]

Thus, although we usually take positions quite similar to those of Alberto Xavier expressed in his brilliant comments, we firmly believe that he confuses the external aspects of a tax with its essence. We cannot accept that a special tax may be considered to have characteristics different from those of the regular tax just because it employs different collection techniques.

The supplementary income tax (which is withheld) and the regular income tax are identical, differing solely in their external aspects, i.e. with respect to their collection methods mentioned in the law.[23]

IV. THE BASIS FOR THE CALCULATION OF THE SUPPLEMENTARY INCOME TAX

After these introductory remarks we will examine the problem which is discussed by tax experts and which has been the subject of litigation, i.e. whether the supplementary income tax assessed on excess remittances in the previous 3-year period may be the basis for computation of the tax payable in the following 3-year period.

Article 43 of Law 4,131/62, as modified by Law 4,390/64, provides:

> The amount of net profits and dividends effectively remitted to individuals and legal entities residing or with head offices abroad is subject to a supplementary income tax whenever the average of remittances in a 3-year period, starting in 1963, exceeds 12% of registered capital and reinvestments under Arts. 3 and 4 thereof.
>
> § 1– The supplementary income tax provided for in this article shall be levied in accordance with the following table:
> - between 12% and 15% of profits on the capital and reinvestments – 40%;
> - between 15% and 25% of profits – 50%;
> - above 25% of profits – 60%.
>
> § 2– Such supplementary income tax shall be withheld on the occasion of every remittance exceeding the 3-year average referred to in this article.

On the other hand, item 10 of Federal Revenue Ruling 77/78 sets forth that:

> Secondly, remittances shall be considered in their net amount, that is, the tax assessed under Art. 344 of RIR/75 being deducted. The basis for calculation, however, shall not exclude the amount of the supplementary income tax relative to the previous 3-year period, which, to facilitate collection, is deducted from the remittance itself.

A mere comparison of both texts shows that the inclusion of the supplementary income tax assessed in view of the excess remittance of the previous 3-year period in the basis for computation of the following 3-year period is set forth in a ruling and not in the law.

This interpretation of a legal provision by a ruling which expressly states that the supplementary income tax must be included in the taxable base makes one wonder whether such inclusion is implicitly prescribed by the law. Thus the question remains whether the ruling would, within the 3 principles mentioned above, merely be stating the meaning of the legislature, or whether it would introduce an additional obligation.[24]

This is exactly what we are going to discuss in this paper.

The legal text, first of all, does not contain *even a suggestion* that

> one shall not exclude the amount of the supplementary income tax relative to the previous 3-year period from the basis of computation.

What the text does contain is a different statement that the tax shall be deducted and withheld on the occasion of every remittance exceeding the 3-year average referred to in the article.

The FR Ruling and the law deal with 2 completely different matters: the ruling adds an amount corresponding to the tax deducted to the taxable basis which is represented by the remittances; and the law considers the withholding tax merely as a collection technique.

The theory expounded by the FR Ruling increasing the taxable base is nowhere to be found.

On the contrary, the law clearly provides that "the amount of profits and dividends effectively remitted" should be considered, which means the sums which have not *efficiently* been remitted, i.e. the sums which not *effectively* left the country and which have not *effectively* been received by the recipient, may not be used as basis of computation for the supplementary income tax.

In interpreting the law, words may not be carelessly used and thus misused. Every word has its own meaning and its sole and unique value, allowing for an exclusive interpretation.[25]

When the legislature states that only *effective* remittances are subject to the supplementary tax, it does not

22. As to this matter, we have already expressed our opinion in a report published by the *Revista Legislação e Jurisprudência Fiscal (Estudos LJF* 6, June 1980) under the title "Natureza Jurídica do ICM".
23. Dejalma de Campos clearly states the need for the law to hold the complete set of requirements: "This principle has a double concept: it obliges the legislature to formulate taxation-legislative commands with a rigorous absolute provision; it obliges the enforcer of law to exclude subjectivism in the enforcement of the law, the legal or administrative creation of taxation law, and the prohibition of analogy and discretion" *(Caderno de Pesquisas Tributárias* 6, *Resenha Tributária*, p. 218-219.
24. Commenting on Arts. 108 and 111 of the National Taxation Code, A.J. Franco thinks it is possible to render explicit a presumably implicit norm whenever the result represents a tax increase *(Comentários ao Código Tributário Nacional*, vol. I, José Bushatsky, edited by Hamilton Dias de Souza, Henry Tilbery and Ives Gandra da Silva Martins, 1974, pp. 147-237).
25. Francisco Ferrara *(Interpretação e Aplicação das Leis*, 2nd edition, Coimbra, 1963, p. 129) states that worse than a literal interpretation of the literal legal text is a forced interpretation, adding to the legal text what one would like to have included, or eliminating what is not in accordance with one's own preferences.

mean *"effective* remittances and those which are neither *effective* nor *remittances*". The placement of adjectives by the legislature can, if teleologically interpreted, very clearly only be understood to mean that the tax should be assessed solely on what *actually* leaves country.

This is so because the introduction of the supplementary income tax is aimed at preventing foreign currency to flow away which would result in the removal of resources which the country needs so much, and which, although legitimately acquired, are thus encouraged to remain in Brazil and discouraged to leave the country.

In such light, only the sums leaving the country are subject to the supplementary income tax, for the legislature has only focussed on this situation. And, to avoid any doubts, it added the adjective *effective* to the noun *remittance,* or, more precisely, it used an adverb in the drafting of the legal text, the expression "effectively remitted".

To accept the introduction of a provision not written in the law would mean considering the Federal Constitution, the National Taxation Code, all principles of taxation law and the ordinary law unneccessary, and to grant to the Revenue the right to introduce and increase taxes not based on any legal provision.

The principles analyzed aboved are quite clear on this matter. To accept the FR Ruling means that the supplementary income tax will be increased, which is a blatant breach of Art. 97, item II of the National Taxation Code, which states:

> Only the law may determine:
>
> . . .
>
> II. The increase in taxes or a reduction thereon, provisions of Arts. 21, 26, 39, 57, and 65 being observed;

Here, once more, the legislature resorted to the strength of an adverb to exclude delegation of legislative competence, as it states that *only* the law (which means that *solely* the law, *exclusively* the law, *nothing but* the law) may increase taxes.[26]

When Alberto Xavier defended a treatment for the supplementary income tax different from that of the regular tax, excluding the latter and including the former in the basis for computation, he did so because he differentiated between the legal nature of the taxes and equated the different collection techniques with the structure of the taxes, which, as we have demonstrated, are similar.

As they have the same legal nature, the supplementary income tax, like the regular income tax, cannot serve as a basis for computation, otherwise the legislature would expressly state so, which, as has sufficiently been demonstrated, it did not.

Recently, the famous professor, chairing a round table at the *Office of Legal Studies* on international investment together with the author of this paper and who at that event acted as the representative of the *Instituto dos Advogados de São Paulo,* examined the legal nature of the supplementary income tax and admitted the possibility of revising his previous position, as the vast majority of the participants was favorable to the position expressed by the author.

Widely covered by the press, the round table was held on 15 July 1981 at the head office of the *Instituto dos Advogados de São Paulo.* A summary of the debates was published by the newspaper *O Estado de São Paulo,* and a more detailed report by the newspaper *"Diário de Comércio e Indústria"*.[27]

Not only a number of participants in the round table, but also many commentators reacted unfavorably to the interpretation of Professor Alberto Xavier.[28]

It is noteworthy that the FR Ruling itself, when it gives examples of the manner of calculation, has not considered the interpretation given by its item 10 and has

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26. In "O Princípio da Legalidade no Direito Tributário Brasileiro" *(Caderno de Pesquisas Tributárias* 6), we have written that: "In fact, in taxation law, it is only possible to study the principle of legality through an understanding that the formal provision in law is not sufficient for its characterization. The principle of the formal provision in law would allow for a certain discretionary power, which cannot be admitted either in criminal law or in taxation law."
As Sainz de Bujanda says in *Hacienda y Derecho* (Madrid, 1963, Vol. 3, p. 166): "the provisions in tax law may not be only formal, they must also be absolute. The law must contain not only the fundaments, the basis for the behavior of the enforcer, but also, and mainly, the very criterion for decisions in the concrete case. This requirement of a "lex scripta" peculiar to the formal provision in law, is added to that of "lex stricta", peculiar to the absolute provision" (pp. 336-337).

27. *O Estado de São Paulo,* p. 26, 25 July 1981.

28. Nilton Latorraca in *Legislação Tributária* (Atlas), p. 212: "Finally, there is another statement in FR Ruling CST 77/78 which goes against the legal norm. We refer to item 10, where it is said that the basis of computation shall not exclude the amount of the supplementary income tax relative to the previous 3-year period, which is deducted from the remittance. It so happens that the tax is not deducted from the remittance, but "debited to the account of the beneficiary abroad, to be deducted on occasion of subsequent remittances" (RIR, Art. 559 § 1). "Deducting on occasion of the remittances" means failing to remit. And as the supplementary tax is only assessed over amounts effectively remitted abroad (RIR, Art. 559), we do not see a way to calculate the tax over the same tax debited to the account of the beneficiary of the profit or dividend."
Hiromi Higuchi in *Imposto de Renda das Pessoas Jurídicas* (1981), p. 309: "FRR 77/78 item 10 states that remittances are considered at their net value, that is, the withholding tax is deducted under Art. 555 of RIR/80. The basis of computation, however, shall not exclude the amount of supplementary tax relative to the previous 3-year period which, for a mere simplification of collection procedures, is deducted from the remittance itself. We do not see the reason for which the supplementary tax is considered a profit or a dividend effectively remitted if, in fact, the amount of the tax is deducted from the profit or dividend to be remitted in the following 3-year period. The very legal provision leaves no doubts as it provides that the amount of net profits and dividends effectively remitted to individuals and legal entities residing or with head office abroad is subject to a supplementary income tax whenever the average remittances in a 3-year period exceed 12% of capital and reinvestments registered with the Central Bank of Brazil. The supplementary income tax has the purpose of controlling the outflow of foreign currency, that is why the law considers only those net profits and dividends effectively remitted."
Carlos Alberto Baroni, in "O Parecer Normativo 77/78 e o Imposto Suplementar de Renda. O que são Remessas líquidas?" *(Boletim de Estudos Jurídicos do Investimento Internacional* 2, p. 26, *Informações Objetivas – IOB e Gabinete de Estudos Jurídicos do Investimento Internacional:* "As to this aspect, however, we disagree with the interpretation given by the FRR, because it does not seem lawful to us to include the tax paid in the previous 3-year period in the basis of computation. Analyzing the above-mentioned Art. 43 of Law 4,311, we understand that the only possible interpretation is that the supplementary income tax relative to the previous period must be excluded from the basis of computation. Our opinion is based on the fact that the article says, "profits and dividends effectively remitted", and the supplementary income tax is not a remitted amount.
Our opinion is reinforced by items 35 and 41 of Regulatory Instruction SRF of 9/12/69.
"Item 35: Net profits or dividends *effectively remitted to individuals and legal entities residing or domiciled abroad . . ."*
As we can see, the two texts above expressly refer to "net profits or dividends effectively remitted". Thus it does not seem to us that the intention of the law was to include in this net amount the gross amount of the supplementary income tax".

made its computation based on *remittances effected* and not with these remittances plus the supplementary income tax of the previous year, which clearly demonstrates the addition of item 10 represents a misinterpretation corrected in the example.

The adverb *effectively* eliminated any possibilities of creating *legal fictions,* which certainly cannot be accepted as an act of the very authority interested in the collection of the tax. Legal fictions can be created *solely by law.*[29]

As demonstrated above, it is our opinion that the supplementary income tax collected in the previous 3-year period may not be used to compute the taxable base for the supplementary income tax assessed in the following 3-year period, because this would represent a "bis in idem" (double taxation). Its manner of computation should follow the same system used for the regular income tax, for neither Law 4,131/62 nor Law 4,390/64 indicates otherwise.

V. MANNER OF COMPUTATION

The seond aspect under discussion relates to the computation of the 3-year period as, also in this matter, the Revenue has adopted a position disadvantageous to the taxpayer.

Although the legislature provided that remittances exceeding 12% per year of the average capital cause the supplementary income to become due, it is evident that, due to the fact that the computation is made over a 3-year period, the rate will necessarily be multiplied by 3, as the total assessed refers to 3 years.

It is interesting to note that this multiplication is acknowledged by the administrative authority itself in the "a contrario sensu" interpretation of the subtraction factors of those fiscal years in which remittance percentages were beyond the 12% mark, when it states, according to item 41 of Regulatory Instruction 2/69, that:

> Remittances of the 2 last years of the 3-year period shall be considered in the 2 first years of the following 3-year period pursuant to effectively remitted amounts, except when they have already been part of a 3-year period in which there was excessive remittance, and the respective tax has been paid, in which case they will be computed only on the value corresponding to 12% of the average capital of each of these years.

It is the Revenue which states that the subtraction shall be done

> in accordance with the value corresponding to 12% of the average capital of *each of these years* (our emphasis).

If one admits that each year must be considered separately and that the 3-year period must be split up in 3 separate years, the logical consequence of what is stated in the Regulatory Instruction is that one admits that 12% corresponds to one year, 24% to two, and 36% to three.

Therefore, when Art. 43 mentions 12% per year, it undoubtedly means each year of the 3-year period, that is, for the calculation of the 3-year period one could only mean the multiplication of the percentages by 3, under the risk of reducing the range applied to each rate of the tax.

If we take the example of FR Ruling 77/78 (see Appendix), we will see that the correct computation would be:

	Capital	Ranges	Excess value in the range	Rate	Tax
FRR computation:	1000	12 to 15%	30	40%	12
		15 to 25%	100	50%	50
		above 25%	230	60%	138
		TOTAL	360		200
Correct computation:	1000	36 to 45%	90	40%	36
	1000	45 to 75%	270	50%	135
	1000	–	–	–	–
		TOTAL	360		171

As one can observe, the tax assessed would be only 171 and not 200. And if one applied the formula to determine over what percentage the tax would have started in each year, one would see that:

$$171 \times 12\% = 200 \times X \text{ (or } X = 10.26\%)$$

which means that the tax would become due on remittances in excess of 10.26% of the capital per year, and not 12% per year or 36% per 3 years, as provided for in Art. 43.

Commentators unanimously agree that the 3-year computation cannot be done on a per year basis.[30]

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29. On this issue, see Ruy Barbosa Nogueira's "Da interpretação e da aplição das leis tributárias" *(Revista dos Tribunais,* 1965), in which he always eliminates the intended flexibility of the regulation of the norm and lets the right of the weakest party prevail in the taxation relationship.

30. Hiromi Higuchi (note 28): "FRR 77/78, item 24, has in our opinion given an example of the computation of the supplementary tax with a wrong result. If the average capital were 1,000 and the excessive remittance 360, the supplementary income tax would be 171, 90 being computed at the 60% rate. The computation was incorrect because he did not consider the 3-year period. The 40% rate is assessed on the excess over 3% per year, therefore, in a 3-year period, such rate is computed over the amount exceeding 9% of the average capital."

Nilton Latorraca (note 28): "there is a basic mistake in this computation: it compares excess remittances of 3 years to ranges determined for annual remittances. However, as acknowledged in item 6 of the FRR, the assessment of the excess remittance is done on a yearly basis. Thus, the excess of 360 considered for the 2nd 3-year period was calculated in view of a 120 annual limit, computed on a capital of 1,000. Therefore, as is provided by the law, profits between 12% and 15% over capital and reinvestment are subject to the 40% rate, and so forth.

According to the legal system, we would then have an annual excess of 120, subject to a tax of 57:

Capital	*Ranges*	*Excess in the range*	*Rate*	*Tax*
1,000	12% to 15%	30	40%	12
	15% to 25%	90	50%	45
		120		57

Should the 120 excess correspond to the annual average, the tax would have been 57 throughout the 3 years, thus amounting to 171 (57 × 3), as computed in the FRR CST 77/78."

Alberto Xavier (note 16): "Second principle of full offsetting: Considering the 3-year character of the basis for computation, a logical corollary results in the *principle of offsetting* within the 3-year period, computation of the limits year after year not being necessary. But, on the other hand, from the unity of that basis, it follows that the principle can only be operated *within each period,* offsetting beyond the limits of the 3-year period not being possible. As the legislature assumed the 3-year period as a time measurement, it did not take into consideration the manner in which the corporate taxpayer organizes its distribution schedule within the period. It is sufficient within this 3-year period that remittances not exceed 36% of registered capital and re-investments".

Henry Tilbery, in "Aspeçtos Polêmicos de Imposto Suplementar de Renda"

To adopt a different, odd, and incoherent criterion, trying to base the tax payable in a 3-year period on an annual computation is to thwart the logical application of the tax law. The interpretation adopted is not logical, it is not provided for in the law and it is more burdensome to the taxpayer and thus violates the principles of strict legality, of characterization, and of the provision in law. In addition, it violates another provision of a superior law, i.e. Art. 112 of the National Taxation Code:

> Taxation law defining offenses, or attributing penalties to offenses, shall be interpreted in a manner which is favorable to the defendant whenever there is a doubt as to:
> I– the legal classification of the fact;
> II– the nature or material circumstances of the fact, or the nature or extension of its effects;
> III– the authorship, imputability or punishability;
> IV– the nature of the applicable penalty or its grading.

The official interpretation seems to lead to the result that, whenever doubt arises, the interpretation adopted should penalize the taxpayer, which is absurd and cannot be admitted even for the sake of argument in view of the clear legislative intention.[31]

We feel that the fiscal authorities are incorrectly interpreting the law and that the 3-year computation should have the corresponding ranges, as indicated in the legal text, multiplied by 3, since the law requires such multiplication when it refers to the annual basis.

The official interpretation therefore, is illegal, because it considered a minimum percentage range inferior to 12% as taxable base. FR Ruling 77/78, in the example, started the supplementary assessment starting with remittances of 10.26% per year.

If the computation of a tax would result in a tax increase lacking any legal base, such computation is illegal, because any increase of taxes is the sole competence of the law.[32]

These are the most relevant legal aspects of the issue and those which we deem of interest to the readers of the *Bulletin,* which can be summarized as follows:

(a) inclusion of the supplementary income tax levied on the previous 3-year period as the basis for computation of this tax of the following 3-year period is incorrect;

(b) the percentage defining the range of assessment of this tax, in Art. 43, shall be multiplied by 3 because the computation of the tax payable encompasses a 3-year period, and one cannot consider the adopting of an annual criterion for the computation of the excess during a 3-year period.

(Resenha Tributária, secção 1.3, ano XII, p. 71*)*: "Moreover, the full *offsetting possibility* between "excesses" and "remainders", *within the 3-year period,* is the key to the system, a principle which is uncontestedly and universally accepted, even though different opinions do exist as to other aspects of the issue. A "ratio legis", obviously, is to give a greater flexibility to the company, for instance allowing it not to remit dividends in 2 consecutive years in order to preserve the working capital, and effecting a bigger remittance only in the third year, of up to 36%."
Dalton Maranhão, in "O sistema de cálculo do Imposto Suplementar de Renda e o PN 77/78" *(Boletim dos Estudos Jurídicos do Investimento Internacional* 2, p. 33): "In addition, such system seems to lead to distorted values when it takes the excess (159,000) above the 36% of the average capital and reinvestments in order to submit it to taxes which start above excesses of 12%."

31. As we said in the beginning, "discouraging taxation" has some characteristics in common with "punitive taxation", so that Art. 112 must always be interpreted to the benefit of the taxpayer, as Aliomar Baleeiro wrote: "Using different words, as regards the penalties, the National Taxation Code said that the restrictive character of the Criminal Code is to be observed, resorting to analogy – except for isolated opinions. Here, too, the saying "in dubio pro reo" holds true. "Benigna amplianda", although it does not acknowledge an equation of fiscal laws to the "lege odiocese" as they were called by old authors" *(Taxation Law).*

32. Art. 97, item II of the National Taxation Code.

APPENDIX

FEDERAL REVENUE RULING CST NO. 77, 4 SEPTEMBER 1978

3.10.00.00 – Income of those residing or domiciled abroad
3.10.40.00 – Supplementary income tax

Supplementary Income Tax (Art. 43 of Law 4,131, of 3 September 1962):

Assessment. Make-up of the 3-year periods. Calculation of the excess remittances. Computation of the tax.
We are here examining issues relative to the supplementary income tax, involving a great part of its system.
We shall analyze the different aspects separately for a better understanding of the problem.

Specific legislation

2. The supplementary income tax was introduced in its present form in Art. 1 of Law 4,390 of 29 August 1964, which modified Art. 43 of Law 4,131, of 3 September 1962, which is the basic legislation concerning capital invested in the country. (Law 4,131/62 was regulated by Decree 55,762, of 17 February 1965.)

3. According to Art. 43, which is the legal matrix of Art. 348 of the Income Tax Regulation approved by Decree 76,186, of 2 September 1975, net profits or dividends effectively remitted to individuals or legal entities residing or domiciled abroad are subject to a supplementary income tax when the average remittances in a 3-year period exceed twelve percent (12%) of the capital and reinvestments registered at the Central Bank of Brazil.

4. The Fiscal Administration has issued supplementary norms to Art. 43 of Law 4,131/62 through Regulatory Instruction SRF 2, of 12 September 1969, with the modifications introduced by Regulatory Instruction SRF 17, of 30 April 1971.

Time aspect

5. In the case of the supplementary income tax, the tax liability is a function of two independent variables (profits and dividend remittances, and capital and reinvestments) along a period of time: 3 years.

6. Although remittances made in a period of 3 years are taken as the basis of computation, the tax is assessed whenever the twelve percent (12%) limit is exceeded at the end of the 3-year period. Therefore, starting in the second 3-year period, calculation of the excess is made on a yearly basis, hence allowing for annual tax

liabilities, not triennial, always based on the amount of remittances in the 3-year period.

7. Item 40 of Instruction no. 2/69 made it clear that, in accordance with the provisions of Art. 43 of Law 4,131/62, the 3-year period is made up of calendar years.

8. It is now worth clarifying the initial term to determine the 3-year period.

For investments prior to 1963, 1963 is the first year of the period. Later investments shall consider as the first year the year in which the application for registration of the initial investment was submitted.

Amounts computed for remittances

9. Supplementary income tax is assessed over excess remittances, therefore only those amounts effectively remitted abroad are computed, even if they correspond to proceeds earned in previous years.

10. Secondly, remittances are accounted for in their net amount, that is, the tax levied under Art. 344 of RIR/75 being deducted. However, the basis for calculation shall not exclude the amount of supplementary tax relative to the previous 3-year period, which, to facilitate collection, is deducted from the remittance itself.

11. Finally, in accordance with provisions contained in item 36 of Regulatory Instruction SRF 2/69, for the purpose of assessment of the supplementary income tax, expenses which are not deductible in the calculation of real profit of a legal entity with head office in the country are considered profits.

Amounts attributed to capital

12. In accordance with the provisions of Art. 43 of Law no. 4,131/62, amounts transferred for capital and reinvestment are those registered at the Central Bank of Brazil.

However, computation of pending amounts "ex vi" item 39 of Regulatory Instruction SRF no. 2/69 are admitted.

13. In the calculation of the average capital, capital and capitalized profits shall be computed proportionately to the time in which they remained in the company during the 3-year period (item 38 of R.I. 2/69).

14. Thus, invested amounts shall be weighed as a function of the time they were present in the company, in conformity with the following formula:

$$\text{average } K = \frac{K_0 \times t_0 + K_1 \times t_1 + K_2 \times t_2 \ldots K_n \times t_n}{T}$$

Where: K = capital (investments and reinvestments)
t = number of days the capital was present
T = number of days in the 3-year period

Verification of the occurrence of excess

15. As we have seen above, the excess subject to taxation is calculated on a yearly basis after completion of the first 3-year period, which means that the 2 last years of a period will be the 2 first years of the succeeding period.

16. We shall now examine the point on which doubts existed, that is, which amounts are to be considered as remittances in the transfer from one 3-year period to the following. The specific question concerns the possibility of offsetting remainders observed in a 3-year period (the amount under 12%) with excess remittances in the following period.

17. In accordance with item 41 of Regulatory Instruction SRF 2/69, as modified by Regulatory Instruction 17/71, remittances of the 2 last years of a 3-year period are considered in the 2 first years of the following 3-year period:
(a) for the amounts effectively remitted, and
(b) for amounts corresponding to twelve percent (12%) of the average capital of each of such years whenever they are part of a 3-year period in which there was an excess.

18. The supplementary norm did not move away from the provisions of Law 4,131/62 when it set forth the criterion for the make-up of the 3-year period, because the latter, in Art. 43, determines that the computation of any excess be made with respect to the 3-year period, therefore the amount remitted in each year is not important, the excess of a year being offsettable against the remainder of any other year of the same period.

19. But, if offsetting is allowed among the years of a given period, the same reasoning does not apply to the transfer to the following period, since the law itself established that the calculation on the excess is limited to the excess occurred within each 3-year period. Thus, as a rule, amounts transferred are those effectively transferred.

20. Except for those situations in which there was an excess in the preceding period, amounts transferred shall be those corresponding to twelve percent (12%) of the average capital of each of the last 2 years of the period and one should not compute excess remittances already subjective to tax. In this manner, one avoids assessing the supplementary tax with respect to the same fact more than once.

21. For a better understanding we give an example in which capital is considered as not having changed, in the amount of 1,000 units, for the period 1970 to 1974:

Three-year period	Years	Capital (investments and reinvestments)	Effective remittances
	1970	1,000	0
1.	1971	1,000	120
	1972	1,000	240
			360
	1971	1,000	120
2.	1972	1,000	240
	1973	1,000	360
			720
	1972	1,000	120
3.	1973	1,000	120
	1974	1,000	100
			340

Permitted remittances	Excess	Remainder	Supplementary tax
120	–	120	
120	–	–	
120	120	–	
360	120	120	none
120	–	–	
120	120	–	
120	240	–	there is
360	360		s/360
120	–	–	
120	–	–	
120	–	20	
360		20	none

Computation of the tax

22. The supplementary income tax is a progressive tax. The excess remittances in a 3-year period are divided into parts to which the rates are attributed.

23. Total tax payable is a result of the aggregation of the amounts obtained through the application of the rates to each of the parts, according to the table below:

Rates	Excess remittances
40%	between 12 and 15%
50%	between 15 and 25%
60%	above 25%

24. Hence, in the example above, an excess of 360 (2nd 3-year period), which is therefore in excess of 25% of the average capital (1000), the supplementary tax shall not be that resulting from the mere application of the 60% rate on such amount, which would result in a tax of 216, but 200:

Capital	Ranges	Amount of excess in the range	Rate	Tax
1000	12 to 15%	30	40%	12
	15 to 25%	100	50%	50
	above 25%	230	60%	138
	TOTAL	360		200

25. Finally, in accordance with provisions of item 42 of Regulatory Instruction SRF 2/69, as modified by Regulatory Instruction SRF 17/71, the tax shall be assessed within 30 days of the end of the 3-year period to which it corresponds in order to be deducted in later remittances.

Conference Diary

OCTOBER 1982

Management Centre Europe: International Tax Management (including: Inter-company pricing of goods; inter-company licensing; service fees; inter-company loans; handling of disputes between tax administrations) (Seminar). Nice (France), October 11-12 (English).

Steuer-Telex-Seminar: Hidden profit distribution in practice. Munich (German Federal Republic), October 30 (German).

NOVEMBER 1982

Management Centre Europe: 11th International Finance Conference: Changes in international finance and their implications for business (including: Financial and tax incentives aimed at attracting investments). Geneva (Switzerland), November 3-5 (English).

Management Centre Europe: Leasing; techniques and analyses (including: Tax aspects of leasing). Brussels (Belgium), November 17-19 (English).

DECEMBER 1982

Management Centre Europe: Taxation of International Group Companies and Branches (including: Taxation of branches and subsidiaries; taxation of shareholders; domestic and tax treaty "anti-avoidance" measures) (Seminar). Brussels (Belgium), December 2-3 (English).

Management Centre Europe: International cash management (including: International tax aspects in cash management). London (United Kingdom), December 6-8 (English).

Management Centre Europe: Stanley B. Lubman on China (including: The joint venture income tax law; the tax on individual income; the tax on foreign enterprises; recent regulations and interpretations by central and local tax authorities). Brussels (Belgium), December 9-10 (English).

OCTOBER 1983

37th Annual Congress of I.F.A.: I. Tax avoidance/tax evasion. II. International problems in the field of turnover taxation. Venice (Italy), October 10-15 (English, French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

Confédération Fiscale Européenne (C.F.E.): Secrétariat Général, Postfach 1340, Dechenstrasse 14, D-5300 Bonn 1 (Federal Republic of Germany).

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.

Steuer-Telex-Seminar: Dr. Peter Deubner Verlag GmbH, Abteilung Seminare. Postfach 410268. 5000 Köln 41, Federal Republic of Germany.

BERMUDA:

Fiscal Structure of a Low Tax Country

by H.W.T. Pepper

An island of 21.5 square miles, 600 miles from the nearest land, Bermuda, with a population of about 54,000, has limited natural resources, but does a rather splendid job of maintaining itself without calling for aid from industrial countries. Bermuda has fine harbours and some useful types of limestone or coralline bed-rock which can be used for building and roofing material. The islands have a pleasant climate, full employment, and excellent personal relations within a mixed population of about 60% black and 40% white residents.

Tourism is the main industry, but Bermuda also functions as a highly respectable financial centre, specialising in international insurance and in financial trusts. Apart from ship and boat repairing there is a perfume factory and medical services are provided for sick persons on passing vessels who can be brought in by helicopter. There is a U.S. air and naval base and the personnel help to maintain the airport.

The Bermudan dollar is maintained on a par with the U.S. dollar - both currencies circulate freely within the country.

Contents

Budget

The country's Budget has been kept in surplus for each of the past 5 years, no mean feat when world tourism has been hit by fast rising fuel costs and air fares over the past few years. Bermuda has, in fact, no doubt because of the excellence of the service provided, managed to maintain healthy levels of tourist visits.

Fiscal "shape"

It used to be conventional wisdom that a country's fiscal structure should be roughly equally divided between direct and indirect taxation. Direct taxes would not normally burden the low income groups who would usually be within the exemption limits. Indirect taxes were practical because they were easier to collect, if levied at import or factory-gate level, and automatically covered a wider tax base while the regressive effects could be mitigated by not taxing food and by applying the higher rates of tax to luxuries.

Bermuda, as a country with no taxes on corporate or personal income and none on capital gains, nevertheless does manage to come near the old guidelines, by drawing a relatively high proportion of revenue from direct taxation, including some fairly moderate levies which fall on the tourist rather than on local wage-earners.

About 45% of revenue comes from customs duties, and wharfage charges at seaports and airport could be classified along with those duties. The remainder comes from a series of levies, including payroll taxes and stamp duties and from profits made from public services such as postal and transport services, so that the fiscal structure may be reasonably regarded as well-balanced.

The fact that the Budget has been in surplus for the last 5 years and that there is no national debt is also a tribute to the island's fiscal policies which, besides being well-balanced, display a measure of ingenuity and are efficiently administered.

Exemption guarantee: income taxes

In a low tax country, newcomers may fear that at some future date income taxes may be introduced. An exempted company may, however, apply to the relevant Government ministry, for an undertaking that in the (unlikely) event that corporation tax, dividend tax etc. might at some future date be imposed, the company will remain specifically exempted therefrom up to the year 2006.

Exchange control

Virtually all exempted companies are designated by the Bermuda Foreign Exchange Control Authority as "non-resident" for exchange control purposes.

Banks and insurance companies are exempt from Exchange Control which, however, applies to residents of Bermuda who pay a 10% levy for their foreign investments.

The levy also applies to interest on overseas loans taken out to finance foreign investment, and, of course, to the repayment of those loans.

Interest rates

Maintenance of exchange control makes it possible for interest rates to be kept low. The maximum bank lending rate is 7% although up to 2% may be added as a service charge. The maximum interest rate allowed to depositors is also 7%.

Customs duties

Although producing 45% of revenue, customs duties are not unduly heavy. Duties are levied not on c.i.f. but on an f.o.b. basis. This has a healthy effect on keeping prices of imports competitive because the weight of duty would be the same on goods originating from halfway around the world in Hongkong, South Korea, Japan, etc., and those coming from the eastern seabord of the U.S.A. The standard rate of customs duty is 22% but some luxuries, e.g. boats, television sets, motor cars, bear duty at 33% ad valorem. Food is imported duty free and there are no internal commodity or sales taxes. See also "Budget changes" below.

Wharfage fees

There are, however, minor taxes on commodities in the form of wharfage fees charged at 1% ad valorem on goods imported by sea. The revenue yield goes to the Hamilton Corporation (Local Authority). A similar 1% charge is levied upon goods imported by air, the yield from which is shared by the Corporation of St. George, and the Central Government. Under the Agreement regarding the American naval and helicopter base, the cost of maintaining the airport and runways is undertaken by the Americans.

Charges on services

There are taxes on services referred to in the notes on Hotel Occupancy Tax and the Tax on Condominiums and Time-Shared Properties. Other charges are referred to under Social Security. The fact that the Post Office and Government transport services (buses and ferries) make moderate profits amounts to a form of levy on the users which comes in on the revenue side of the Budget. Of course, it is essential that the services should show a surplus so that adequate provision may be made for replacement of equipment to maintain the services efficiently.

Hotel occupancy tax

A tax of 5% on room charges is levied and there is a parallel charge in the case of certain types of letting of apartments. (See Condominiums, Time Sharing.) The tax is not levied on the precise charge for the room occupied but on a standard value known as a "rack rate".

Condominiums and time-sharing tax – services tax

There is a 10% tax, payable to the Ministry of Home Affairs on the cost of buying a condominium. The 10% rate also applies to the cost of buying a "Time-Sharing" interest in a property.

Where the owners of a condominium or of a Time-Share of a property pay fees for maintenance and other services, or "club dues" as they are sometimes called, a 5% tax applies, similar in a way to the Hotel Occupancy Tax.

Time-Sharing schemes do offer scope for possible sharp practice by the sponsors, but in Bermuda all money collected must go into escrow and a Trust Fund must be set up to protect the interests of the investors.

Transportation taxes

Vehicle licenses are payable annually and charged within the following ranges.

Motor cars

The fee varies from \$80 to \$240 according to the length of the vehicle.

Commercial vehicles

The fees vary from \$160 to \$1200

Motor cycles and motorised bicycles

The fees vary from \$8 to \$40. The maximum engine capacity permitted is 100 c.c.

Other charges related to transportation are referred to under Passenger Terminal fees.

Passenger terminals

A departure tax of \$5 is charged on outgoing air passengers to cover administrative expenses at the airport. There is no charge on incoming or transit passengers, nor on children under 2 years old. A fee of \$10[1] is charged on outgoing passengers at maritime passenger terminals.

Employment tax

Employment tax, basically a 5% payroll tax, has a similar tax base to Hospital Levy (see below), except that fringe benefits are included. The tax also applies to the self-employed on the same basis as for the Hospital Levy.

Exemptions and abatements

Small businesses, i.e. where payroll is less than \$36,000 per annum, are exempt from the tax. Where payroll does not exceed \$100,000 per annum, an abatement in the form of a deduction of \$1,000 per month is made.

Complete exemption is accorded to international companies, registered charities, and public bodies, as well as to certain individual entrepreneurs, e.g. farmers, taxi-drivers, and commercial fishermen.

Abated tax rate

The 5% rate is abated to 2% for hotels and restaurants and for hotels the rate is reduced to zero for the low season of tourism, viz. the 3 months of December, January, and February.

Social security

Hospital Insurance is compulsory and is administered by the Hospital Insurance Commission. The full cost of hospital treatment for children up to 16 years of age, and 80% of the cost to persons over 65 years of age is paid by the Government which imposes a Hospital Levy (see below) to produce the required funds.

Social Security can be a troublesome, open-ended commitment which can create havoc with Budgets. It has done so, for example, in Britain, Holland and the U.S.A. so that using commercial financial institutions to

1. To be increased to 20% from 1 April 1983.

provide the bulk of medical services through contributions by the beneficiaries makes excellent fiscal sense. The system also creates a stronger feeling of self-reliance among the public. Once taxpayers are led to expect all things to be provided by Governments, the appetite for aid quickly grows, Budget imbalance increases and public morale falls, processes which the Thatcher and Reagan Governments in Britain and the U.S.A. are presently trying to reverse.

Hospital Levy

This is a levy at 3% on all employers' payrolls.

The employers may collect 1½% from their employees. Gratuities, an important source of income for hotel employees, do not enter in the calculation. Taxable fringe benefits do not include payments by the employer for employees' health insurance, pensions and life assurance.

The tax is payable also by international companies, but on a notional basis, i.e. the pay of their employees in Bermuda is estimated at $21,000 per annum for tax purposes. The employer has the right to collect 1½% of the tax from the employee but only up to the limit of his actual pay should this fall short of the notional $21,000.

Self-employed

The self-employed are also taxable, on a figure equivalent to their own earned income from their business or profession. The gross income from a business or profession will normally include substantial elements relevant to the provision of premises, equipment, etc., whereas the hospital levy is intended to relate only to what the self-employed might receive for his services if all else were provided by others.

Abated rate

(a) Government, parishes, churches and charities are liable only at the rate of 1½% of payroll. Again the tax may be deducted from the employees' pay.
(b) For other employers where the payroll is less than $36,0000 the tax rate is reduced from 3% to 2%.

Payment

Tax is payable quarterly, within 15 days of the end of March, June, September, and December. If an employer did not deduct the tax when paying his employees' remuneration he must still pay the tax in full but has no legal right to make retrospective deductions from the employees.

The tax is collected jointly with Employment Tax (see above) and both levies are entered on a single form.

Land tax

Land tax is charged on improved values of land which is developed for houses, apartments, commercial or industrial businesses or used for quarries or as storage areas. Agricultural land is exempted. The yield is intended to help pay for services relating to health, education, police and for fire and ambulance services.

Revaluations are made quinquennially and tax is charged as a percentage of annual rental value (ARV).

Exemptions

(a) Properties owned by the Crown, local government, charities, schools, and by foreign governments, e.g. Embassies, are not taxed.
(b) Persons aged 65 or more who own and occupy property with an ARV of $6,300 or less are exempted from land tax.
(c) In cases of financial hardship, abatement or exemption may be granted by the Accountant General.
(d) Property incapable of occupation, e.g. premises severely damaged, which require renovation or substantial repair may qualify for relief from tax for the period when occupation is not possible.

Basis of valuation

The ARV is based on the fair rental per annum which a reasonable owner might expect from a reasonable tenant from the property in an unfurnished condition. No form of abatement is allowed for property which is in a bad state of repair – on the other hand no extra tax is charged on property which is exceptionally well maintained.

Rent control applies to residential units with an ARV of $7,500 or less and this is taken account of for land tax purposes.

In practice property tax assessable values are about 2/3 of the gross current rentals charged.

Dates of payment

The tax is payable half yearly but if property is mortgaged to a financial institution tax is usually collected by the institution on a monthly basis along with the mortgage repayment and interest.

As a device to assist with land tax collection, a person who wishes to register a motor car must, when applying, quote the street name and house number or valuation number of his residence.

Rates of tax

Properties with ARV's from $240 to $2,220 pay tax at 3% and the rates graduate to a maximum of 20%. These graduated rates apply to residential property and *a rebate of 5%* is deducted from the gross tax computed at those rates, where payment is made promptly.

Commercial and Industrial properties are taxed at a flat rate of 6.25% of the ARV.

Transfer taxes

Transfer taxes in the form of stamp duties are payable on
(a) the sale or transfer of real estate at ½% on the first $50,000 and 1% on the excess;
(b) transfers at death are taxed by a stamp duty on the total value of the estate at a rate of 3% on the first $100,000 and 5% on the remainder; and
(c) transfers inter vivos are taxable at ¼%.

2. There is a 10% levy on the Transfer of ownership of real estate by non-Bermudians.
3. Investments overseas by Bermuda residents are taxed under Exchange Control provisions at 10%. The same levy is charged on repayments of foreign currency loans and on investments in foreign currency.

Stamp duties

Apart from the stamp duties referred to under Transfer Taxes, there are also minor duties on certain financial transactions and most legal documents.

0.2% stamp duty is charged on the nominal value of any mortgage, bond, or debenture issued by a company, and 0.25% is charged on the authorized capital (and additions thereto) of Exempted Companies (see Company Registration Fees, below).

Company registration fees

Companies in Bermuda are divided into 3 categories –

(a) *Exempted companies* are those incorporated in Bermuda, but exempted from the requirement to register the nationalities of their shareholders, and which operate *outside* Bermuda from a principal place of business *in* Bermuda.

The minimum capital for an exempted company is $12,000. In the case of an insurance company the minimum is $120,000 fully-paid-up.

An exempted company cannot acquire a mortgage on land in Bermuda nor any bonds or debentures secured on Bermuda lands. Such a company cannot carry on trade or business in Bermuda either directly or by acquiring an interest in any other concern trading in Bermuda. There are, however, no restrictions on its trading outside the country.

(b) *Local companies* are those which may trade or do business *in* Bermuda. Such companies must have at least 60% of their shares and voting rights in the hands of Bermudians.

(c) *Non-resident companies* are those incorporated outside Bermuda and which operate *outside* Bermuda from a principal place of business *in* Bermuda.

Initial registration fees

Local companies, and *exempted* companies are registered in Bermuda and are subject to initial registration fees (in the form of stamp duties) of 0.25% on authorised capital.

For *non-resident companies* the initial fees are $2,250 for –

(i) Insurance (excluding management and brokerage);
(ii) Mutual funds;
(iii) Finance business; and
(iv) Management of Unit Trust Scheme (the fee is payable for each separate scheme).

The same fee is charged as an *annual* charge (see also below), sometimes referred to as "franchise fees". A fee of $1,200 (initial and annual) applies to the following types of activity. Both levels of fee are being increased by the 1982 Budget.

(v) Insurance management and brokerage;
(vi) Other types of business.

Annual fees

Local companies. The annual fees for local companies were increased by the 1982 Budget to a range of $500 to $5,000 p.a. according to the amount of authorised capital.

The annual fees payable by companies licensed to operate under various Acts, such as the Banks Act of 1969 and the Deposit Companies Act of 1974 are also being increased by the new Budget.

Business fees are payable annually to the Registrar of Companies not only for the different types of business carried on by companies, but also for the work of professional *personnel employed in certain activities.* The following fees, which are being increased by the 1982 Budget, applied at the beginning of 1982 –

Insurance manager	$500
Insurance broker	$500
Insurance agent	$500
Insurance salesman	$ 25
Real estate agent	$100
Real estate salesman	$ 10

Betting tax

There is a 20% levy on off-course betting stake-money, and also on football pools stake-money.

International futures exchange tax

A tax, announced in the 1982-83 Budget, is to be imposed on the revenue from futures transactions, but the transactions will be exempt from stamp duties.

1982-83 Budget changes

Broadening the tax base

Some of the measures announced in the 1982-83 Budget are designed to broaden the tax base rather than raise the level of taxation on the existing base. It is intended to extend the *Employment tax* to employees of international companies, at present exempt, and also to extend the *Hospital Levy* to that section of the emoluments of hotel and restaurant employees which comes from mandatory service charges on customers. Both steps are logical ways of making the coverage of the two levies more comprehensive. A new source of revenue will be the charges on international futures transactions mentioned above.

Indexing of existing levies

A number of levies in Bermuda have remained unchanged for some years, and the present Budget is designed partly to do a little catching up, in the case of *vehicle licences* only to the modest degree of a 10% increase, from which small cars will be exempt.

In the case of *land tax,* the revaluation will bring in new values for assessment which will only have the general effect of increasing the tax level by about 15% from 1 January 1983.

Annual company etc. fees are also overdue for increases and the Budget Speech which appears in this edition outlines the general pattern of increase.

Customs duties

Duties on imported materials used in the manufacture of gases, and shades and awnings are to be exempted, and the exemption is also to be extended to spare parts for agricultural equipment and certain marine navigation equipment.

A switch to ad valorem duties on fuel oils is to be made – the timing is appropriate because the price of such fuels is at present very stable, but when prices rise the tax will rise in parallel. The new rates will be slightly higher on gasolene and diesel oil, but a 50% decrease is being made in the duty on cooking oil and smaller decreases in the duties on kerosene and fuel oil as a sort of social benefit.

BERMUDA:

Budget 1982-83

Extracts from the Budget Speech pronounced by the Honourable J.D. Gibbons, J.P., M.P., Minister of Finance, on 26 February 1982.

To summarise, Mr. Speaker, the Current Account Estimates contain provision for expenditure of $ 139.7 million and the Capital Account Estimates of $15.2 million. The latter sum provides for $ 12.3 million in respect of development projects, both continuation and new, and $ 2.9 million in respect of Capital Acquisitions. Altogether, this brings the total expenditure budget for 1982/83 to just under $ 154.9 million.

Although staff costs, the grant to the hospitals and many other items of current expenditure will be significantly higher in 1982/83, payments on the public debt will be limited to interest and service charges on temporary bank borrowing at a saving of $ 4.6 million, and capital expenditure is also predicted to be $ 0.7 million below expected outlays in 1981/82. This makes the task of balancing the budget somewhat easier than might first have been thought. Some increases in taxation are necessary but not on the scale announced on this occasion last year.

Local company annual taxes have remained unchanged since 1964 and an adjustment is long overdue. An increase which reflected the decline in the value of money over that time would result in at least a trebling of current rates. However, in recognition of the burden imposed on companies from other forms of taxation, fees will be raised to slightly more than twice their current level. Currently the annual tax ranges from $ 240 to $ 1,200 depending on the capitalisation of the company. The new rates will range from $ 500 to $ 2,500 for companies with a capitalisation of less than $ 1 million. For companies with a capitalisation of $ 1 million or more the annual tax will be $ 5,000. The increase in revenue from this source will be around $ 450,000. In addition, licence fees for banks, deposit companies and companies licensed under the 1969 Companies Act will also be increased. The annual licence fee for banks will be increased from $ 7,500 to $ 25,000. For deposit companies the licences issued to companies under the 1969 Companies Act will increase from $ 240 to $ 1,000. Licence fees for real estate agents and salesmen will also be raised. These changes will provide an additional $ 135,000.

An increase in Motor Vehicle Taxes, of about 10%, will take effect from 1 May 1982. However, in order to encourage the use of small cars, the tax on the smallest two classes of private cars will remain unchanged. The rise is expected to yield an additional $ 450,000.

Revised assessments of annual rental values will be in force by 1 January 1983. I intend to bring proposals to this House which will revise the progressive rate schedule so as to yield an additional $ 1 million in a full year, equivalent to about 15% of the current annual yield. Honourable members will wish to note that this increase only partially restores the real value of receipts from this source which have fallen by over one third during the past five years. As I stated earlier, additional revenue is required to finance Government's commitment to provide adequate mortgage money at a reasonable cost to borrowers. It seems only fair that those who have benefited from the low domestic interest rate over the years, and whose land tax bill has largely remained unaltered despite inflation, should be asked to contribute to the resolution of our housing problem.

A number of changes will be made to the Customs Tariff Act. Although their overall effect on revenue will be small, the most significant changes will be made in duties on petroleum products. As I told the House last year, I intend to replace the existing specific rates of duty on bulk fuels with ad valorem duties. The change to ad valorem will also involve a restructuring of existing rates. As a result there will be a 2c per litre increase in the price of gasolene, BELCO fuels, and oil for ships bunkers. Prices of kerosene and fuel oil will, however, fall marginally. Although these changes will, overall, provide a small net increase in revenue, most of this will be offset by a halving of the current 20% duty on cooking gas.

As has been pointed out by the Energy Conservation Committee, cooking gas has up to now been taxed relatively heavily in comparison to competing fuels, once account is taken of its higher thermal efficiency. The reduction in duty will rectify this anomaly. The above changes will take effect with the passing of legislation to be introduced during the budget debate.

Tariff concessions will be given for some of the raw materials used in the local manufacture of gases, and of shades and awnings. The range of aids to the disabled or chronically ill eligible for exemption from duty will be brought up to date. An exemption will also be provided for parts of agricultural equipment and certain marine navigational aids. A drawback of most of the dutiable content of fine artwork sold abroad after exhibition will also be introduced. Several amendments of a technical nature will be proposed including clarification of the tariff treatment of dressmaking patterns and a recasting of the present tariff item dealing with the importation of boats.

There will be a further change in the treatment of export liquor packages. Following the decision by U.S. Customs to switch to metric allowances for their returning tourists, provision will be made for 2 litre and 4 litre packages replacing the current standard U.S. gallon package with duty rate of $ 1.00 and $ 1.50 per package respectively. The provisions for storage charges for packages at the Queen's Warehouse at the Airport will be revised to reflect the new metric sizes.

A tax on the trading revenue of the new International Financial Futures Exchange will be instituted. The tax will yield at least $ 100,000 in the first full year of the Exchange's operations due to commence in July. Revenue in later years will depend on the volume of transactions conducted on the Exchange. Transactions on the Exchange will, however, be exempted from Stamp Duty and a bill including the relevant amendment together with several other changes, including a higher level of relief on house purchase, will be introduced shortly.

Taxes associated with timesharing developments also figure prominently in the estimates for the coming fiscal year. Timesharing Occupancy Tax, which is levied on the sale or resale of a timesharing interval, is expected to bring in a further $ 2.1 million. However, receipts in future years will be on a much smaller scale. Timesharing Services Tax, which is levied on the service charge paid by owners of intervals, is expected to yield $ 25,000 in 1982/83.

As the House is aware, Departure tax for cruise ship passengers is to be raised to $ 15 for the coming season. The resulting additional revenue will be of the order of $ 585.000.

Rental charges for postal boxes which were last fixed in 1973 will be substantially increased providing an additional revenue of $ 60,000 per annum.

Preliminary discussions have been held with some representatives of international companies regarding their privileged position in respect of employment tax. It is widely recognized that their exemption from this tax is anomalous and distorts the labour markets, in some cases placing local firms at a disadvantage. Consideration will be given to proposals later in the year which will have the effect of taxing the notional payroll of international companies at an equivalent rate to that currently applied to the payrolls of local companies.

Government's plans to apply Hospital Levy to gratuities paid to hotel and restaurant workers, where these are paid out of a mandatory service charge collected by the employer, are being pursued with the Union and I am hopeful that a solution can be found.

Mr. Speaker, against a background of an assured expansion of economic activity it is relatively easy to budget for a growth in the real level or government expenditure with the confidence that revenue will be sufficient for us to pay our way. However, following a year when real GDP has probably declined, renewed growth in 1982/83 is by no means certain. We have had to trim our expectations to meet economic reality while at the same time concentrating our efforts in those areas, especially housing, where action is required. I am confident that the proposals I have set before you represent a sound financial strategy for the year ahead. However, I trust that the House has a full appreciation of the uncertain times before us and is under no illusion as to the dangers of failing to resolve our differences, particularly in the area of labour relations. Our future prosperity depends on the mutual support of all members of our community. On this cautionary note, Mr. Speaker, I respectfully submit the budget for 1982/83.

Tax Policy in Middle-Income Countries: Some Lessons of Experience*

by Vito Tanzi**

I. CHARACTERISTICS OF MIDDLE-INCOME COUNTRIES

Many studies have dealt with the tax systems of groups of countries with common characteristics (Hinrichs; Musgrave; Tanzi, 1970 and 1981; Messere); however, they have concentrated either on "poor" countries, alternatively referred to as developing or less developed, or on "developed" or "industrialized" countries, often belonging to groups such as the Organisation for Economic Co-operation and Development (OECD) and the European Economic Community (EEC), or, at times, on countries belonging to the same geographical area. To my knowledge there has been no specific analysis of countries that may no longer be properly called poor but that at the same time may not yet be considered fully developed or industrialized.

Different criteria could be followed in defining these in-between countries. One possibility would be to follow the *World Development Report* of 1980, prepared by the staff of the World Bank. That report defines middle-income countries (MICs) as those which, in 1978, had per capita gross national product ranging from US$390 (for Egypt and Ghana) to US$3,500 (for Israel). According to this criterion, 52 countries can be classified as being MICs. I feel somewhat uncomfortable with this particular definition, as it covers an income range that is much too wide and includes countries that are just too different to be in the same group. Just how broad is the *World Development Report's* definition of an MIC can be seen from the following observation. It covers a group in which the per capita income of the richest country is almost ten times that of the poorest country. By contrast, in the same report the per capita income of the richest country in the group of "low-income" countries is only about four times that of the poorest. The same relative range separates the richest from the poorest of the "industrialized" countries.

The *World Development Report* breaks the group of the MICs into three subgroups: (a) semi-industrialized, (b) mineral economies, and (c) predominantly agricultural economies. In this paper I shall concentrate on those MICs with per capita gross national product (GNP) ranging from US$1,000 to US$3,500 in 1978. This group includes the 24 countries shown in Table 1. Most of these countries are semi-industrialized. Ten of them are from the Western Hemisphere.

Before discussing the tax systems of these countries, it is perhaps useful to outline, briefly, the broad changes that take place in the economic structure of countries when they move from lower-income groups to that of the MICs as defined in this paper (see Chenery and Syrquin; Chenery 1979). On the production side, the share of primary production falls sharply while that of industry (especially manufacturing and utilities) and services rises equally sharply. As we shall see later, this change has important implications for the kind of tax structure that becomes feasible in these countries. The change is also accompanied by some increase in the ratio of imports to GNP, and by increases in exports coming mainly from the manufacturing sector. The allocation of labor also changes although much less dramatically than that of production: the proportion of labor in industry rises while that in the primary sector falls. This change brings into the open the underutilization of labor that may exist in the

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countries and creates pressures on the governments to pursue employment-creation policies. Life expectancy increases significantly and comes close to that of the industrialized countries. This change has obvious implications for social security programs and for payroll taxes. These countries are also much more urbanized than lower-income countries. This factor creates more opportunities for taxation but also more demands for public services, as urban dwellers consume much more of these. Besides the changes outlined above there are three aspects that distinguish the MICs from either lower-income or higher-income countries. These three aspects have important implications for their tax systems.

First, as a group, these countries have experienced much higher rates of growth than other groups *(World Development Report, 1980)*. For the 1960-78 period, their average per capita annual growth rate was 4.0%. Eight of the 24 countries included in this group had per capita annual growth rates over that period of more than 5%. By contrast, the group of countries with per capita income of less than US$390 had an average growth rate of only 1.6; the countries with per capita income ranging from US$390 to US$1,000 experienced a rate of growth of only 2.6; and the industrialized countries had a rate of growth of 3.7. To the extent that these growth rates reflect governmental policies or objectives, there are obvious implications for their tax systems.

Second, these countries have experienced much higher rates of inflation than the other groups. For the 1970-78 period, the group's annual rate of inflation was over 30%, although this average was somewhat distorted by the extreme experiences of Chile, Argentina, and Uruguay. Most of the MICs expierenced annual rates of inflation of more than 10%. When inflation becomes such a serious problem, it can no longer be ignored by the tax authorities. Unless adjustments are made to the tax system, it will end up being distorted to such an extent that it would bear little resemblance to the system that the authorities had originally intended to have.

The third aspect relates to the distribution of income. Several studies have shown that the distribution of income follows a kind of U-shaped curve, as the proportion of national income received by the poorer sectors of the population decreases at first as the level of income rises. It then reaches the bottom of the curve and starts rising again to reach the level common to the industrialized countries (Kuznets; Ahluwalia).

> *As national income rises from the lowest observed level to that of middle-income countries, the share received by the poor [lower 60%] declines on average from 32% to 23% of the total. In a hypothetical country following this average relationship, 80% of the increase in income would go to the top 40% of recipients.* (Chenery, 1980, p. 28)

According to Chenery, the most uneven income distribution is reached at a level of per capita GNP (at 1978 prices) of around US$1,500. After that the income distribution starts improving, first slowly, then more significantly.

Table I – Basic indicators for middle-income countries

	Population (millions)	Area (Thousands of square kilometers)	GNP per capita: U.S. dollars	GNP per capita: Average annual growth (per cent)	Average annual rate of inflation (%)		Adult Literacy rate (%)	Life expectancy at birth (years)	Average index of food production per capita (1969-71 = 100)
	mid-1978	meters)	1978	1960-78	1960-70	1970-78	1975	1978	1976-78
Malaysia	13.3	330	1,090	3.9	-0.3	7.2	60	67	110
Jamaica	2.1	11	1,110	2.0	3.8	16.9	86	70	98
Lebanon	3,0	10	....	....	1.4	....	....	65	85
Korea (Rep. of)	36.6	99	1,160	6.9	17.5	19.3	93	63	116
Turkey	43.1	781	1,200	4.0	5.6	21.5	60	61	110
Algeria	17.6	2,382	1,260	2.3	2.3	13.4	37	56	82
Mexico	65.4	1,973	1,290	2.7	3.5	17.5	76	65	99
Panama	1.8	76	1,290	2.9	1.6	7.5	78	70	103
Taiwan	17.1	36	1,400	6.6	4.1	10.3	82	72	105
Chile	10.7	757	1,410	1.0	32.9	242.6	88	67	94
South Africa	27.7	1,221	1,480	2.5	3.0	11.7	....	60	100
Costa Rica	2.1	51	1,540	3.3	1.9	15.7	90	70	114
Brazil	119.5	8,512	1,570	4.9	46.1	30.3	76	62	117
Uruguay	2.9	176	1,610	0.7	51.1	65.6	94	71	105
Argentina	26.4	2,767	1,910	2.6	21.8	120.4	94	71	114
Portugal	9.8	92	1,990	5.9	3.0	15.2	70	79	82
Yugoslavia	22.0	256	2,380	5.4	12.6	17.3	85	69	117
Trinidad & Tobago	1.1	5	2,910	2.2	3.2	21.3	95	70	94
Venezuela	14.0	912	2,910	2.7	1.3	11.1	82	66	97
Hong Kong	4.6	1	3,040	6.5	2.3	7.7	90	72	30
Greece	9.4	132	3,250	6.0	3.2	13.8	....	73	120
Singapore	2.3	1	3,290	7.4	1.1	6.1	75	70	112
Spain	37.1	505	3,470	5.0	6.3	15.0	....	73	122
Israel	3.7	21	3,500	4.2	6.2	31.0	88	72	113

Source: International Bank for Reconstruction and Development (IBRD), *World Development Report, 1980*, p. 111.

This pattern of income distribution has at least two important implications for tax policy. First, as the poorer 60% of the population receives a relatively small share of total income, tax policy could concentrate on the richer 40% without any significant effects on tax revenue. This concentration, of course, would considerably reduce administrative difficulties. Second, as income distribution becomes more uneven, the pressure on the government to introduce progressive taxation becomes stronger.

II. ECONOMIC DEVELOPMENT AND TAX STRUCTURE

1. General aspects

Although there is little interest in the subject at the present time, the relationship between economic development and changes in tax structures attracted the attention of several researchers some years ago. The theory of tax structure change during economic development hypothesized that, as countries move from earlier stages of economic development to higher stages, some clearly discernible changes would be witnessed in their tax structure.[1] First, the ratio of direct to indirect taxes would fall at first, as traditional taxes on land would be replaced by other more convenient taxes such as those on foreign trade. Second, as countries develop, foreign trade taxes would progressively be replaced by domestic indirect taxes. And, finally, income taxes would gain in importance. This theory emphasizes the *economic* influences on tax structures, influences associated mainly with the varying importance of tax bases or "tax handles" (Hinrichs; Musgrave).

To a large extent, the theory ignores social, cultural, and political influences. It also ignores technological innovations which may, at particular moments in time, introduce new taxes which, given the proper environment, may become important (Tanzi, 1973). Therefore, given the economic structure of a country, its tax system may vary substantially depending on the relative strength of these political, sociological, or cultural factors. Furthermore, even when the changes in the broad tax categories follow the pattern outlined by the theory of tax structure change, the particular characteristics of those categories may be very different. These characteristics are also very important but have received little attention.

The tax systems of some Latin American countries have been influenced by the tax systems of European Latin countries. Those of other Latin American countries have been influenced by the U.S. tax system. The tax systems of the French-speaking African countries bear a close resemblance to that of France. And the same is true for former British colonies vis-à-vis the United Kingdom. Furthermore, depending on the political coloring of the governments in power, some aspects of the tax systems may reflect greater or lesser concern for the distribution of the tax burden. Keeping in mind these cultural or political influences, one could still postulate a kind of deterministic theory of tax structure change. Such a theory would indicate the general characteristics of the tax systems that one could expect to prevail in the MICs.

To start with, the change in the structure of production gives the MICs more options than are available to poorer countries. As foreign trade still remains very important in these countries, the MICs could continue relying on foreign trade taxes. On the other hand, since domestic production outside of the primary sector, and especially in the manufacturing sector, has become much more important, the MICs have the option of replacing foreign trade taxes with domestic indirect taxes. Furthermore, as the share of gross national income received in the form of wages and salaries or in the form of corporate profits is likely to have increased, they can also rely more on income taxes. Finally, an increasing share of national wealth is represented by buildings in the urbanized areas. The value of these buildings can be assessed much more easily than that of land; therefore, the possibility of relying on property taxes has also increased considerably.

However, even though more possibilities have been created by the changes in the structure of the economy, some new considerations become important, and these may limit somewhat the degrees of freedom acquired by the MICs. For example, some of these countries may attach a lot of importance to the objective of economic growth at a time when income distribution is becoming less even. Therefore, an important consideration in the tax policy of these countries must be the balancing of the growth objective against that of income redistribution. Some countries will want to give more weight to one objective; others will give more weight to the other. These political choices should affect their tax structure.

One of the characteristics of these countries is a higher rate of inflation. As they will often find it difficult to eliminate these inflationary pressures, they will have to pay attention to the impact that inflation will have on taxes. Without an explicit recognition of the problem, some tax sources (for example those on net wealth) might disappear, while others (general sales tax) might become more important. These inflationary pressures may in time bring about an increase in the level of taxation, especially when they are caused by fiscal deficits created by strong middle classes demanding greater expenditures for public services such as education, health, and social security.

For these countries, the temptation of generating revenue through an inflation tax must be tempered against the recognition that inflation will bring about serious distortions in the economy and that these distortions will inevitably affect both the rate of growth of the economy and its international competitiveness. It must also be tempered by the recognition of the effects of the inflation tax on other sources of revenue (Tanzi, 1978).

2. Specific aspects

Let us consider now, briefly, some of the major tax categories and speculate on the differences that one could expect to find between the proper countries and the MICs.

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1. For a brief, critical overview of this theory, see Tanzi, 1973.

a. Export taxes

In the MICs, there should be little scope for permanent export taxes. These should be eliminated unless they are kept for very specific, non-revenue-related reasons. For example, coffee producing countries that want to stimulate the domestic production of instant coffee might keep an export duty on the export of coffee beans. Temporary export taxes might also be used to reduce the windfalls that exporters may derive from large devaluations. These uses should be infrequent and limited, and one would expect to find little revenue associated with the export taxes in the tax system.

b. Import duties

The pattern that one would expect in a country's use of import duties merits some attention. In less developed countries, import duties represent the most important taxable base. At this level, one expects that a large share of the country's revenue originates from this source. It can also be expected that, to a certain extent, these taxes will be imposed with specific rates rather than with ad valorem ones. As countries begin to develop, the protective role of import duties will gain in importance. Public opinion will generally favor protection at this stage of development. As domestic production of non-primary products rises, the revenue and the productive roles will get mixed together. By the time a country reaches middle-income status, and alternative bases have become available, the revenue role of the import duties should become less important. If they are retained, they should be mainly for their protective role. However, as these countries become more export-oriented, the inefficiencies associated with import duties will begin to be recognized by both the policy-makers and the people at large. Therefore, protection will become a lively issue.

The next step for a MIC might be to replace the highly differentiated and protection-motivated import duties with more uniform rates that would provide some uniform level of protection to all industries rather than highly differentiated protection to specific ones. This seems to be the course followed by Chile at this time. At this point, of course, import duties would be levied with ad valorem, rather than with specific rates. This general level of protection should be progressively lowered and in time should disappear. Incidentally, if this general import duty rate were levied on all imports without exemption, the country might still get substantial revenues from this source even with low rates.

The pattern described above will inevitably have negative effects on some industries. Therefore, it may come about only after strong resistance has been overcome and after countries have already developed well beyond the level where it should have taken place. Undoubtedly, some countries will prevent this change from occurring: (a) for revenue reasons (but this is not a valid argument, as revenues can be generated through other sources), or (b) to continue providing protection for industries already in place. This second reason would be strengthened when the removal or the lowering of duties would lead to some social unrest or to political difficulties for the government in power.

c. Income taxes

At low levels of development, most of the revenues from income taxes are derived from large, and often foreign, corporations. The share contributed by individuals is relatively small and is normally limited to wages and salaries paid by governments or by these large corporations. Other sources of personal income pay almost nothing. At this early stage, income taxes are often schedular. The level of personal exemptions is very high, often amounting to several times the per capita income of the country. The marginal tax rates are reached at extremely high income levels (say 100 times the per capita income), the number of taxpayers is very small, tax incentives and tax evasion are widespread, and the impact of inflation on these taxes is ignored.

By the time the middle-income level is reached, several changes can and should take place. The share of the individual's contributions to total income taxes should increase because of, for example, (a) the broadening of the tax base (especially increases in wages and salaries in national income), (b) the reduction of the level of exemptions, and (c) the improvement in tax administration.

At this level of income, the limitation of the tax incentive legislation in achieving various goals should have been recognized, and the erosion of the tax base caused by incentive legislation and by evasion should have become an issue. At this level, some issues would move to the forefront of the discussion on tax policy.

The first issue should concern the progressivity of income tax. Here, the experience of different countries indicates that *high* marginal tax rates create many problems and they contribute little to revenue. A high marginal tax rate can clearly reduce or eliminate the base on which it is levied. Therefore, a good policy is one of pursuing an income tax with rates that are progressive, but not exceedingly so, and that are levied on as broad a base as possible. This approach not only minimizes the disincentive effects of high tax rates but also reduces the problem of horizontal inequity, a problem that becomes extremely acute when the rates are high on those who cannot evade them while those who can evade them end up paying little or nothing. A consensus seems to be developing that the higher marginal tax rate should not exceed 50-60%.

The structure of the personal income tax should be related to the distribution of income. The basic exemption should be tied to a level of income that would exempt a good share of the population without exempting too much of the total income. This objective is facilitated by the uneven income distribution that characterizes most of these countries (Tanzi, 1966). The level to which the marginal tax rate becomes relevant should also be related to the income distribution. A simple rule could be to make this rate applicable at a level of income near that received by the top 1% of the population.

Another basic issue relates to the use of incentives. As already indicated, by the time countries reach the middle-income level, they should be aware of the futility of trying to promote efficiency and growth by the use of fiscal incentives. Therefore, this is a good time to start dismantling the incentive mechanism that inevitably has accumulated over past years.

A third issue, which has not really been solved by any country, concerns the difficulty of taxing the incomes of professionals, farmers, traders, independent contractors, and so forth. Perhaps for these incomes, the true or objective income cannot be determined. Therefore, the tax authorities should give up the futile effort to determine true, actual incomes and should instead develop alternative means of taxing these incomes through presumptive or potential taxation. Some experience along these lines is available in a few countries (Uruguay, Costa Rica, Portugal, Israel, etc.). (See Tanzi, 1980.)

Another issue relates to the problem of what to do about the effects of inflation on the income tax. Should these effects be ignored, neutralized, or taken advantage of in order to increase revenue? These effects will be related either to the distortion of income tax bases (interest, profits, capital gains, etc.) or to the progressivity of the rate structure. The effects related to the progressivity are easier to deal with. In all cases, the role played by delayed collections cannot be ignored (Tanzi, 1977).

Two extreme examples of reaction are provided by Uruguay and Turkey. In Uruguay, the authorities came to the conclusion that a personal income tax could not survive an inflationary environment; therefore they abolished it. Turkey ignored the effect of the inflation on the tax liabilities of wages and salaries, so that the rate structure was not adjusted. Given the progressive nature of this tax, the fact that it is collected with hardly any delays, and given the rate of inflation that has prevailed in current years (it averaged 21.5% annually for the 1970-78 period), the share of personal income taxes in GNP increased from 4.5% in 1970 to 9.4% in 1980. As a proportion of total tax revenue, the share of personal income tax increased from 28.7% in 1970 to 51.6% in 1980.

The correction of income tax bases for inflation is very difficult and has been attempted only on a limited scale in some MICs (Brazil, Chile, Israel, Korea and Argentina). One important issue is whether the tax system should be made to recognize the difference between the legal and the economic concept of income. This distinction becomes extremely important in an inflationary environment, especially vis-à-vis interest rates, profits, and capital gains. In many of these countries, the repression of the financial market has caused real interest rates to be negative, thus leaving the government with little choice but to ignore the taxation of interest income. For profits, some countries have attempted to introduce adjustments in depreciation, inventories, and so forth; others have, from time to time, allowed a revaluation of assets (Casanegra).

Another issue that is inevitably very important for the MICs relates to the taxation of retained profits vis-à-vis dividends. Some argue that, to promote the capital market, distributed profits should be taxed at lower rates than retained profits. Others argue that the corporation remains the most efficient instrument for reinvesting profits. In my mind, this is an unsettled issue where more country-related research would be beneficial. I have become less and less convinced that favoring distribution is always an efficient policy, even for MICs.

On the part of those who favor distribution, there is an implicit assumption that the corporation that reinvests profits will do it in the same line of activity. This is not what is happening in places like Korea and other fast-developing Asian MICs. In these countries, the corporations have reinvested their profits in those lines of activities that were most profitable at a particular point in time, and these were often totally different from the traditional ones. Branching out is a common phenomenon and for a time can lead to efficient investment.

One must ask the question about what the receivers of dividends would do with them if more profits were distributed. Unless the capital market is already substantially developed (in the sense that interest rates are not kept artificially low, the stock market is not too narrow and is well regulated, etc.), these dividends may either (a) leave the country, (b) be invested in real estate, or (c) lead to additional consumption. When financial reforms have made interest rates highly positive for savers, so that the dividends can be deposited in savings institutions, if the stock market is still undeveloped, the additional dividends may not lead to more equity financing (through the sales of shares) but may lead to an increase in the debt-equity ratios of companies. This will happen because companies will finance the additional capital needs by borrowing rather than by the sale of shares. Such an alternative might be less attractive and more costly than that associated with direct equity financing through the retention of profits.

d. Taxes on domestic transactions of goods and services

As countries move from the less-developed to the middle-income state, some basic changes in the structure of these taxes should be expected. In a schematic fashion, these changes can be outlined as follows.

At the earliest stage of economic development, domestic transactions may not be taxed at all. When they begin to be taxed, it will be through excises limited to a few products (tobacco, alcohol, gasoline, sugar, cement, etc.). Services will normally be exempted, and the excises will be specific rather than ad valorem. The first change that may take place with economic development will be an expansion in the number of products taxed; the second will be some conversion from specific to ad valorem rates.

Sooner or later the need for additional tax revenue will force the countries to expand the scope of domestic indirect taxation. This will take place also to substitute for some foreign trade taxes. A few countries, following the British tradition, may meet this need through a continuous expansion of the system of selective indirect taxation. But the majority will consider the introduction of some form of general sales tax. The sales tax, once introduced, will soon increase in importance as a revenue source. At this early stage the general sales tax will, most likely, have the following characteristics:

(1) It will be levied at a low rate.
(2) It will be applied at the manufacturer's level.
(3) It will be limited to products and will, thus, exempt services.
(4) It will exempt many products for administrative or social reasons.

(5) It will also be collected on imports.
(6) In terms of revenue the share derived from imports will be overwhelming.

Because of (a) the exclusion of services, (b) the limitation to few manufactured products, (c) the exclusion of value added generated by the distribution sectors, and (d) the inevitable evasion, the share of total domestic value added subjected to this tax will inevitably be very small. Therefore, one important step to be followed by countries approaching the middle-income level will be to try to broaden this narrow base. This can be done by (a) reducing the range of exempted products, (b) starting to bring some services into the tax base, and (c) trying to capture some of the value added that originates in the distribution channels. At the same time, the rate may be increased. These changes will bring into the open some of the problems caused by cascading. Therefore, steps will generally be taken to eliminate cascading either through the introduction of the ring system or by the explicit introduction of a value-added mechanism.

By the time countries join the middle-income group, they should have either a value-added tax (VAT) or a single-stage tax without the cascading effects of a turnover tax. Furthermore, the coverage should extend beyond the manufacturer's level although probably not all the way to the retail level. The share of the revenue from the general sales tax derived from imports should have fallen to well below 50%. By this time, the excises should be reduced in number and should be levied with ad valorem rates.

At the stage of economic development reached by the MICs, some issues related to domestic indirect taxation are likely to be hotly debated. First is the question of the proper base for the general sales tax. Most countries have exempted some products (unprocessed food, services) for administrative reasons and some others (books, medicines, basic foods, newspapers, etc.), for social reasons. In some cases, exemptions were given to some activities (cottage industry) as an incentive to the producers. In most cases, the granting of an exemption to one product or producer creates pressures for the same treatment by other producers. The result is an erosion of the base. This process of erosion should become controversial at the middle-income stage of development. Attempts are likely to be made to reverse that process and to enlarge the base. But how to accomplish this is likely to be a hot issue.

A second controversial issue is whether to attempt to make the indirect taxes progressive. Some countries have chosen to have a proportional (single-rate) general sales tax accompanied by some high-rate excises on "luxury" products. Others have attempted to introduce progressivity by leaving multiple rates within the general sales tax, the rate being higher the less "essential" the product is considered to be. Some experts now recognize that high rates on luxury goods yield little revenue and contribute only marginally to the progressivity of the overall tax system (Gandhi, 1979). The main justification for these high rates is essentially political. However, this remains a highly controversial area.

A third issue relates to the taxation of services. It is recognized that taxing services is difficult administratively. However, some experts have argued that taxing of services should make the tax system more productive and more equitable especially at the middle-income stage, where the share of services in national income has increased. A recent study, however, has cast doubts on both of these contentions (Gandhi, 1977).

Table 2 provides some information on the type of general sales tax now in use in 22 MICs. The table indicates the popularity of the VAT in recent years. Nine of these countries have some form of VAT. With one exception, all these taxes were introduced during the past decade. Five of the countries (Jamaica, Trinidad and Tobago, Venezuela, Hong Kong, and Singapore) still do not have a general sales tax, and a couple still have turnover taxes. There is a large variation in the rates of these taxes.

Table 2 – General sales taxes in MICs

Country	Nature of tax	Standard rate
Malaysia	manufacturers	5
Jamaica	none	—
Korea (Rep. of)	VAT (1977)	13
Turkey	manufacturers	various
Algeria	manufacturers	25[1]
Mexico	VAT (1980)	10
Panama	VAT (1977)	5
Taiwan	turnover	2
Chile	VAT (1975)	20
South Africa	manufacturers	10
Costa Rica	VAT (1975)	8
Brazil[2]	VAT (1972)	various
Uruguay	VAT (1972)	18
Argentina[3]	VAT (1975)	16
Portugal[4]	wholesale	10
Trinidad and Tobago	none	—
Venezuela	none	—
Hong Kong	none	—
Greece[4]	manufacturers[4]	8
Singapore	none	—
Spain[4]	turnover	2
Israel	VAT (1976)	8

1. Tax-inclusive rate.
2. Brazil has two general sales taxes (one federal and one state) and a tax on services.
3. Argentina has also a provincial turnover tax with rates from 1.6 to 2.2.
4. Within the next few years Greece, Portugal, and Spain are likely to introduce a VAT.

III. SOME COMPARATIVE TAX STATISTICS FOR MICs

Table 3 provides comparative tax statistics for the MICs in our sample. These statistics must be used with caution, as it is difficult to prepare comparable tax data for different countries. The most important problem is that the information normally available relates to central governments. However, in many countries local governments may be very important; furthermore, social security institutions may be outside of the national budget. An attempt was made in the table to use data that were as comparable as possible, but there is no assurance that the attempt was totally successful.

Table 3 – Tax revenue by type of tax

(in percent of total taxes)

Country	Year	Total taxes	Income taxes: Total	Income taxes: Personal	Income taxes: Enterprise	Income taxes: Other	Domestic taxes on production and consumption: Total	Domestic taxes on production and consumption: General sale; turnover; VAT	Domestic taxes on production and consumption: Excise	Domestic taxes on production and consumption: Other
Argentina	1979	100.0	11.24	—	—	—	54.14	31.09	23.05	0.00
Brazil	1978	100.0	16.72	1.08	6.72	8.92	32.81	—	—	—
Chile	1978	100.0	17.57	10.22	7.08	0.27	49.07	35.60	10.76	2.71
Costa Rica	1978	100.0	17.92	17.77	0.15	0.00	33.21	9.41	23.06	0.74
Greece	1976	100.0	17.45	8.96	3.16	5.33	39.46	18.35	10.99	10.12
Israel	1978	100.0	41.34	26.46	11.17	3.71	32.48	28.75	3.17	0.56
Jamaica	1978	100.0	39.09	25.90	13.19	0.00	45.58	—	—	—
Jordan	1977	100.0	17.98	—	—	—	8.31	0.00	7.87	0.45
Korea (Rep. of)	1979	100.0	28.56	14.64	13.92	0.00	48.65	22.51	17.64	8.50
Malaysia	1979	100.0	39.73	9.67	29.99	0.07	23.04	5.75	10.65	6.64
Mexico	1978	100.0	54.12	27.04	26.62	0.47	30.34	10.98	17.83	1.53
Panama	1978	100.0	38.83	—	—	3.20	31.81	14.26	16.07	1.48
Portugal	1978	100.0	21.76	10.96	0.00	10.80	34.02	14.47	15.19	4.39
Singapore	1978	100.0	44.52	—	—	—	22.72	0.00	9.21	13.51
Spain	1978	100.0	23.74	18.30	5.44	0.00	15.06	3.65	7.96	3.45
South Africa	1977	100.0	62.87	28.69	32.64	1.54	23.85	4.92	18.62	0.31
Taiwan	1978	100.0	19.12	6.30	8.09	4.73	40.56	22.45	1.54	16.57
Trinidad and Tobago	1978	100.0[1]	54.10	27.11	21.25	5.74	16.19	6.53	2.03	7.62
Turkey	1978	100.0	47.93	39.16	4.40	4.37	20.15	9.81	2.16	8.18
Uruguay	1979	100.0	8.85	1.50	7.09	0.26	41.88	22.18	15.73	3.97
Venezuela	1978	100.0	71.16	4.68	66.48	0.00	6.98	0.00	4.51	2.47
Yugoslavia	1978	100.0	0.00	0.00	0.00	0.00	22.28	22.28	0.00	0.00
Average			33.08	16.38	16.09	3.80	30.57	16.65	11.48	5.18

Table 3 (continued). Tax revenue by type of tax

(in percent of total taxes)

Country	Year	Total taxes	Foreign trade: Total	Foreign trade: Import duties	Foreign trade: Export duties	Foreign trade: Other	Social security	Wealth and property	Other[2]
Argentina	1979	100.0	20.24	19.00	0.62	0.62	—	7.04	7.34
Brazil	1978	100.0	4.46	3.56	0.90	0.00	38.22	0.11	7.68
Chile	1978	100.0	8.18	8.18	0.00	0.00	15.38	3.18	6.62
Costa Rica	1978	100.0	22.06	12.91	9.15	0.00	24.69	1.07	1.05
Greece	1976	100.0	5.36	5.36	0.00	0.00	28.23	9.50	0.00
Israel	1978	100.0	8.67	5.57	0.00	3.10	10.52	1.89	5.10
Jamaica	1978	100.0	6.64	6.33	0.00	0.31	0.00	5.04	3.65
Jordan	1977	100.0	70.56	64.94	5.62	0.00	0.00	0.22	2.93
Korea (Rep. of)	1979	100.0	18.87	18.87	0.00	0.00	1.23	0.45	2.24
Malaysia	1979	100.0	34.99	16.63	18.36	0.00	0.60	0.46	1.18
Mexico	1978	100.0	11.97	4.89	7.08	0.00	0.00	—	3.57
Panama	1978	100.0	20.69	11.16	3.31	6.23	0.00	3.93	4.74
Portugal	1978	100.0	6.51	6.49	0.02	0.00	29.76	1.48	6.47
Singapore	1978	100.0	11.64	11.64	0.00	0.00	0.00	15.37	5.75
Spain	1978	100.0	6.34	6.47	0.00	0.00	49.50	5.15	0.21
South Africa	1977	100.0	8.94	8.19	0.75	0.00	1.26	1.56	1.52
Taiwan	1978	100.0	27.02	27.02	0.00	0.00	0.00	9.30	4.00
Trinidad and Tobago	1978	100.0[1]	26.24	26.21	0.00	0.03	0.54	1.42	1.51
Turkey	1978	100.0	11.01	11.01	0.00	0.00	15.02	5.45	0.44
Uruguay	1979	100.0	14.51	14.36	0.15	0.00	29.31	4.29	1.16
Venezuela	1978	100.0	11.34	—	—	—	7.40	2.67	0.45
Yugoslavia	1978	100.0	19.36	19.36	0.00	0.00	58.34	0.00	0.02
Average			17.07	14.67	4.60	2.06	20.67	3.98	3.22

Source: Country source, central government tax revenue only; International Monetary Fund, Government Finance Statistics; revenue statistics of OECD member countries, 1965-79.

1. Non-oil revenue only.
2. Includes stamp taxes, payroll or manpower taxes, poll taxes, and other unallocable taxes.

The key question to ask is the extent to which the statistical information in the table reflects the expectations outlined in the previous section. We shall consider in turn each of the major categories:

(1) We speculated in the previous section that the foreign trade taxes should be less important in MICs than in poorer countries. Table 3 bears this out. On average, only about 17% of total tax revenue is derived from foreign trade taxes, a percentage much lower than for all developing countries. This 17%, of course, hides wide dispersions within the group. In a few countries (Jordan, Malaysia, Taiwan, and Trinidad and Tobago), these foreign trade taxes are still quite important. In others (Chile, Greece, Israel, Jamaica, Portugal, Spain, South Africa), these taxes account now for less than 10% of total revenue.

(2) As anticipated, export duties have become relatively insignificant except in Malaysia, where they still account for 18% of total revenue.

(3) Also as anticipated, income taxes have become more important than in poorer countries. On average, they now account for about one third of total tax revenue compared with about one fourth for all developing countries. But, again, the range is very wide, with a few countries getting somewhat higher percentages from this source (Israel, Mexico, Singapore, South Africa, Trinidad and Tobago, Turkey, and Venezuela). On average, the proportion of income taxes collected from individuals and that collected from enterprises is about the same, but this equality hides important differences. In some countries with important mineral and natural resources, such as Venezuela and Malaysia, the taxes on enterprises are very important. On the other hand, in countries such as Turkey, Spain, Israel, and Jamaica, the taxes on individuals are much more important.

(4) The domestic taxes on production and consumption also reflect the discussion in the previous section. These taxes have now become significantly more important than those on foreign trade and account for about one third of total tax revenue. Excises have become much less important than general sales taxes. This is again as one would have anticipated from the previous discussion. However, excise duties do remain very important in some countries, such as Argentina, Costa Rica, South Africa, Jamaica, and a few others.

(5) The table shows also that social security has become of some importance in particular MICs, especially the European ones. Greece, Portugal, Spain, and Yugoslavia derive large revenues from social security taxes. Among the non-European countries, Brazil, Costa Rica, Chile, and Uruguay derive important revenue from this source. Although the table does not provide that information, social security is also important in Argentina.

(6) Generally, taxes on property and wealth are of some importance in a few MICs. Singapore is particularly notable, as it derives more than 15% of its tax revenue from this source. The highly urbanized nature of this country must surely be the main reason for this high proportion.

IV. TOWARD MORE EFFECTIVE TAX SYSTEMS FOR MICs

The purpose of this section is to present some desirable features that the tax systems of MICs should have. Or, alternatively, to emphasize pitfalls to be avoided. More than in the previous section, the discussion will be normative; however, it will not be based on theoretical or abstract reasoning but rather on a realistic assessment, based on the practical experiences of many countries, about what is feasible from an administrative point of view and what is desirable from a real-world point of view. An alternative to this approach would be to propose some theoretically "optimal" tax system that, though perfect in the abstract, could never be implemented in practice. Unfortunately, it has been a rather frequent occurrence in the field of technical assistance for foreign experts, with little practical experience and little understanding of a country's particular administrative, legal, and political constraints, to propose reforms that, though clever in theory, could never survive the test of reality.

At the level of economic development reached by the MICs, it should be possible for their tax systems to show the following characteristics.

a. Revenues from few sources

As countries move from being less developed to being middle income, a process of concentration of tax sources should take place. Taxes that generate, say, less than 1% of total revenues should not be levied. This criterion should apply not just to tax sources but also to rates within particular tax sources. For example, each rate of the income tax schedule should generate at least that percentage. This criterion would reduce the excessive fragmentation of the tax system and would simplify the administration. It could be relaxed only when a tax has been levied specifically to discourage some activity. How low this "concentration index"[2] can be, can be seen by the experience of Argentina, where in 1975-76 the Dirección General de Impuestos was collecting almost 100 different taxes, most of these generating insignificant revenues and costing a lot to administer or to comply with. No wonder that the Argentine taxpayer felt overtaxed, even though the ratio of total taxes to GNP was not excessive for the country.

b. Tax bases as broad as possible so that the tax rates applicable to them could be kept low

One of the basic problems of the tax systems of poor countries is the extent to which tax bases are eroded, not just by evasion but often by legal exemptions of various types. In one country on which I worked recently, the tax base of what was supposed to have been a general sales tax had been reduced to less than 10% of its national income. The same has happened frequently to income taxes for which, because of exemptions, deductions, incentives, and so forth, the income that is actually taxable

2. The share of total revenue coming from, say, the two or three major tax sources could be referred to as the concentration index.

is a very small share of the potential base. Typically, one also finds that 40 to 60% of total imports are exempted from import duties for one reason or another. This very large erosion of bases brings about the necessity either to increase the number of taxes collected or to increase sharply the rates applicable to the reduced bases. Both of these alternatives are unattractive. Therefore, MICs should set as an objective the implementation of a tax system based on a few large bases levied at relatively low rates.

c. Objectivity in definition of bases

Here, again, a basic distinction should be made between the tax systems of the poor countries and those of the MICs. In poor countries, bases such as income, imports, or property, and, in some cases, even sales, may have an objective or true measure that is often totally different from the measure on which the taxes are actually calculated. For example, for incomes other than wages and salaries, the keeping of records and the accounting may be so bad that guesses replace actual measures; the tax base in these particular cases may end up bearing little relation to the true, objective base. The same is true for import taxes where the import prices used by the customs authorities to calculate the customs duties may be very different from the prices actually paid by the importers; and, of course, the assessed property values used for determining the tax liability bear little relationship to the actual market values.

In the MICs, the difficulties of determining the true tax bases will remain but the countries will have more resources to do it. Unfortunately, in many of them the effort required to bring the taxable bases closer to the true bases has not been made. The end result is that the taxpayer is often left with a feeling of arbitrariness on the part of the tax administration, and this feeling encourages non-compliance.

d. Collection lags minimized

In many countries the time that elapses between the moment a tax event takes place and the moment when the associated tax payment must be made (the "legal lag"), can be quite long (Tanzi, 1977). When there is little inflation this delay does not matter much, but, at the level of inflation now common to most of the MICs, the existence of these long collection lags can dramatically decrease the real value of the tax revenue. In Argentina, for example, in 1975/76 an average collection lag of five to six months for the total tax system, associated with a very high rate of inflation, led to a sharp fall in the ratio of tax revenue to GNP (Tanzi, 1978). Some countries have paid attention to this problem (Argentina, Chile, Brazil, etc.), but in most these lags remain still much longer than they should or need be. Long lags not only reduce tax revenue but create inequities when they are short for some taxpayers (wage earners) and long for others (receivers of capital incomes). In such cases, the effective tax rate for wage earners will become higher than that for other incomes even though the nominal rate may be the same.

e. Severe penalties for delayed payments

One common problem in many MICs has been the accumulation of unpaid tax bills (arrears). In some countries these arrears have reached very large proportions. When the penalties are low and the rate of inflation is high (a common situation in several countries), the taxpayers are given an incentive to postpone paying their taxes beyond the time they are legally due. Borrowing against tax liabilities becomes the cheapest source of credit. These "delinquency lags" become cumulative with the "legal lags" and bring about serious distortions. The problem is that the penalties, which often are in the form of monthly interest rates, were often introduced in periods when there was no inflation so that, for example, a penalty of 1% per month was a stiff one. In today's world, when the monthly rates of inflation for several MICs (Brazil, Argentina, Israel, etc.), are much higher than that, these penalties have lost any meaning. At a minimum, these penalties should reflect the current rate of inflation and should, perhaps, become progressively heavier the longer the payment is delayed. There must be some optimal structure of penalty. This is an unexplored area in which research could make important contributions.

f. Taxes as neutral as possible

Another general aspect of the tax system relates to tax neutrality. At this stage of economic development, the MICs should pay far more attention to tax neutrality, especially since their growth is often export oriented and is thus based on comparative efficiency. The problem of neutrality, of course , becomes less serious the lower the tax rates are. In countries with high export duties on some agricultural products but not on others, taxation has prompted a reallocation of the use of land toward non-taxed crops. And, of course, the export taxes have encouraged domestic consumption while discouraging production. In countries where small cottage-type enterprises are exempted from relatively high sales tax, these enterprises may come to acquire a substantial advantage over the large, more efficient, but higly taxed companies. These examples, which could be multiplied, are common to many countries. As countries become more exposed to international competition, they should become more sensitive to the distortions brought about by inefficient taxes.

g. Public expenditure covered over longer run

If large deficits develop, taxes should be increased or expenditures should be reduced.[3] Unfortunately, as Table 4 shows, in many of these countries the deficits have been extraordinarily large in recent years, and inevitably, these deficits must have been a major cause of inflation. Equally important, recurrent or permanent expenditures should be related to "permanent" tax revenue to avoid that extraordinary tax revenues associated, for example, with temporary export booms lead to permanently higher, and thus unsustainable, expenditure.

3. If a country receives large grants, its expenditure could exceed its tax revenue. But the country should anticipate the day when the grants may no longer be forthcoming. Therefore, it should be careful to avoid expenditures that are permanent.

Table 4 – Fiscal deficits as percentages of GDP

	1973	1974	1975	1976	1977	1978	1979
Argentina	5.5	6.3	11.0	7.9	4.1	3.7	....
Brazil[1]	-2.5	-1.6	0.2	2.6	2.1	3.7	....
Chile[2]	13.5	5.3	1.7	-3.7	-0.4	-1.6	-4.4
Costa Rica	3.5	2.0	2.7	4.6	3.2	4.6	5.8
Greece	2.3	3.2	3.9	3.8	3.6	3.7	4.1
Israel	20.6	23.6	19.0	17.1	17.6	12.0	....
Jamaica	5.2	7.4	7.8	15.5	14.4	16.8	....
Jordan	9.0	7.5	16.1	17.4	6.9	18.6	17.3
Korea (Rep. of)	1.7	2.3	2.0	-0.1	-0.2	-0.2	-0.6
Malaysia	5.6	6.0	8.5	7.1	8.6	7.9	8.3
Mexico	4.3	4.3	5.4	5.3	3.7	3.0	....
Panama	9.8	10.6	7.7	8.2	4.2	3.1	8.8
Portugal[3]	2.1	3.3	4.9	7.0	5.8	11.4	9.9
Singapore	-1.3	-0.1	-2.1	-0.4	-0.6	-0.3	-0.4
Spain	0.7	1.5	1.9	2.0	1.6	2.4	3.0
South Africa	1.0	2.4	6.1	6.4	5.0	5.1	4.4
Taiwan		-3.4	-1.5	-1.4	-0.9	-1.1	....
Turkey	1.7	2.4	2.3	2.0	6.1	4.3	....
Uruguay	1.2	3.8	4.3	2.2	1.5	0.9	0.1
Venezuela	-1.6	-2.1	-0.6	3.8	6.6	6.0	....
Yugoslavia	0.9	1.5	1.3	2.9	1.8	....	....

Source: International Monetary Fund, International Financial Statistics. For a few countries, the information comes from specific country sources.

1. Not including credit subsidies. Inclusion of these subsidies would increase the size of the reported deficit.
2. Overall public sector including the copper industry.
3. General government overall deficit.

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Taxation of Consultancy Fees in Nigeria

by A.C. Ezejelue*

I. INTRODUCTION

In the Budget Speech of 1980 the Nigerian Federal Government proposed, inter alia, the application of deduction of tax at source or withholding tax to management fees, consultancy fees and such similar fees. The rate of the withholding tax proposed was 20% of gross for residents and 25% of gross for non-residents. The effective date for the operation of the withholding tax was to be 1 April 1980. It will be operated by companies making such payments as well as by all government departments, parastatals, statutory bodies, institutions and other established organisations approved for the operation of the PAYE system that make such payments. It was also proposed that such tax withheld in respect of payments due to companies and non-resident persons should be paid over to the Federal Board of Inland Revenue while those in respect of resident individuals should be paid over to the tax authority of the State in which the beneficiary is resident.

As usual, the proposals in the 1980 Budget statement are, where appropriate, expected to be embodied in the 1980 Finance Bill with retrospective effect from 1 April 1980. However, it is not known if there has been an Act of the National Assembly on the issue of withholding tax on consultancy fees. Yet there have been many cases of some withholding tax on consultancy fees, and this has aroused some doubts among many consultants as to the legality or otherwise of the recent withholding tax on consultancy fees without any supporting legislation.

The purpose of this article, therefore, is to explore the legal and/or practical basis for the withholding tax on consultancy fees in Nigeria.

II. BASIS FOR TAXING CONSULTANCY FEES

A. Relevant legislation

Some foreign consultants have often misconstrued our tax laws. It is the understanding of some of them that profits are taxable in Nigeria only if they can be attributed to an established place of business in Nigeria. Accordingly, if there is no such established place of business in Nigeria, as in the case where services are rendered from overseas, the profits therefrom will not be liable to Nigerian tax. This is erroneous.

The relevant sections of the Nigerian Companies Income Tax Act (CITA) 1979 which make such profits taxable in Nigeria are 8(1)(a) and (f) and 11. Section 8 appears to be too wide for this purpose and should be read in conjunction with Section 11.

Specifically, Sections 8(1)(a) and (f) provide that:

> (1) Subject to the provisions of this Act, the tax shall, for each year of assessment, be payable at the specified rate upon profits of any company accruing in, derived from, brought into, or received in, Nigeria in respect of –
> (a) any trade or business for whatever period of time such trade or business may have been carried on;
>
> . . .
>
> (f) fees, dues and allowances (wherever paid) for services rendered.

And Section 11 provides that:

> (1) The profits of a Nigerian company shall be deemed to accrue in Nigeria wherever thay have arisen and whether or not they have been brought into or received in Nigeria.
> (2) The profits of a company other than a Nigerian company from any trade or business shall be deemed to be derived from Nigeria to the extent to which such profits are not attributable to any part of the operations of the company carried on outside Nigeria.

B. Implications of the key terms used in Section 8 of CITA

The meaning attributable to the key terms "accruing in", "derived from", "brought into", and "received in", used in Section 8 of CITA, are worth considering for our purpose.

While "derive" means "to obtain or receive from a source", "accrue" may mean "to come to someone or something as a gain".[1] But in *Commissioner of Taxation v. Kirk*[2], their Lordships attached no special meaning to the word "derived", which they treated "as synonymous with arising or accruing".[3] In this case in which *In re Tinda*[4] was overruled, it was held that income which was

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1. See, for example, *The American Heritage Dictionary of the English Language* (1969-1970), pp. 9 and 356.
2. (1900) AC 588.
3. Op. cit., p. 592.
4. (1897) 18 NSWLR 378.

in part derived from the extraction of ore from the soil of New South Wales Colony, and from the conversion in the latter Colony of the crude ore into a sellable product was assessable under Section 15(3) and (4) of the New South Wales Land and Income Tax Assessment Act of 1895, notwithstanding that the finished products were sold exclusively outside the Colony. However in *Toufic Karam v. Commissioner for Income Tax*[5] the learned judge said (as it would apply to Nigeria):

> The words "accruing in" and "received in" appear to me to import a clear territorial limitation to *Nigeria;* the words "derived from" appear to me to be designed to meet among other things cases where profits arise from transactions carried out in Nigeria by a non-resident taxpayer.

Under our personal income tax system, income from employment shall be deemed to be derived from Nigeria if the duties of the employment[6] are wholly or partly performed in Nigeria.[7] The emphasis is on "derived from" because derivation in this context implies "obtained" or "acquired" or "got" via working or having worked in or for Nigeria. This is to be distinguished from "brought into" or "received in" or (to some extent) "accruing in", which may not necessarily imply worked or working in or for Nigeria. These terms as they apply to companies appear, by implication, to bring into the tax net profits from transactions carried on outside Nigeria by a Nigerian company,[8] but the tax is restricted to profits actually brought or imported into Nigeria.

C. Import of Sections 8 and 11 of CITA

It can be deduced that Section 8 tends to limit tax liability in a geographical sense to profits derivable in Nigeria and to restrict tax liability in respect of transactions carried on outside Nigeria to profits actually brought into Nigeria. However, Section 11 wraps it up with a distinction between a Nigerian company and a non-Nigerian company.[9] Section 11(1) provides that the tax liability in respect of transactions carried on outside Nigeria by a Nigerian company is not restricted to profits brought into or received in Nigeria, but that the world profit of the company for any year of assessment is assessable in Nigeria. Section 11(2) stipulates that the profits of a non-Nigerian company from trade or business shall be deemed to be derived in Nigeria to the extent to which such profits are not attributable to any part of the operations of the company carried on outside Nigeria.

For our purposes, there does not seem to be much distinction between subsections (1)(a) and (1)(f) of Section 8 – i.e. between trade or business on the one hand, and fees, dues and allowances for services rendered on the other. Rendering of services also amounts to carrying on business. When a company is formed with an established objective (which may be rendering of services) and this objective is in fact carried on, then the company is carrying on business.[10]

It must be emphasized that, as in the case of trade or business, it is the profit arising from the fees, dues and allowances for services rendered that is taxable. Therefore all expenses incurred in earning the fees, dues and allowances will be deducted in arriving at the net taxable fees.

D. Legality of taxing consultancy fees

The legal basis upon which fees on consultancy executed in or for Nigeria by foreign-based consultants or by non-Nigerian companies are liable to Nigerian tax is that the fees are *derived from* Nigeria in accordance with Section 11(2) of CITA. They are deemed to be derived from Nigeria once the services are done in or for Nigeria or are paid for by Nigeria, notwithstanding that part of the services may have been carried out outside Nigeria. The existence or non-existence of a permanent establishment or fixed base in Nigeria for the company is not relevant except under an existing double taxation treaty between Nigeria and the country of residence of the company.

A similar provision exists in our personal income tax in the case of a resident abroad who is deemed to be resident, for tax purposes, in Nigeria if the person has spent in the aggregate at least 183 days in Nigeria.[11] In an article on the subject it was said, inter alia:

> The fact of the 183-day criterion is not based on the existence of an established place of residence. Provided that the person spends an aggregate of 183 days in Nigeria, the availability of a permanent abode is irrelevant. Places of temporary lodging will satisfy this particular condition of residence.[12]

In support of the above statement, the author of the article quoted Rowlatt, J. who said, among other things:

> . . . one must remember . . . that one must not look for an establishment . . . . a tramp has a "residence" . . . . if a man chooses to live at hotels instead of in his own house, or even stay with friends, it really does not affect the question of residence.[13]

It is with this same spirit that Section 11(2) of CITA is construed. But under Section 11(1) of CITA consultancy fees of a Nigerian company are deemed to *accrue in* Nigeria from wherever they may have arisen and notwithstanding that they may not have been brought into or received in Nigeria.

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5. 12 WACA 331. See also *Re John Robert Potter* 11 WACA 144.
6. "Employment" includes any service rendered by any person in return for any gains or profits (see S. 4(2)(d) of the Income Tax Management Act (ITMA) 1961 as amended).
7. See S. 8(1)(a) of ITMA 1961 (as amended).
8. "Nigerian company" means any company incorporated under the Companies Act 1968 or any enactment replaced by that Act. (See S. 78 of CITA 1979.)
9. "Non-Nigerian company", which may be considered identical to "foreign company", may mean any company or corporation (other than a corporation sole) established by or under any law in force in any territory or country outside Nigeria. (See S. 9(8)(c) of CITA 1979.)
10. This view is supported by decided cases. See, for example, *IRC v. Westleigh Estates Co. Ltd.* (1924) IKB 390; 12 TC 654; 40 TLR 208.
11. See paragraphs (e) and (x) of Third Schedule to ITMA. See also S. 8(1)(a)(ii) of ITMA.
12. See A.C. Ezejelue, "Impact of Residence on Tax Liability in Nigeria", 35 *Bulletin for International Fiscal Documentation* (1981), pp. 547-554.
13. *Lysaght v. IRC* (1928) 13 TC 511, 516.

III. AMOUNT OF WITHHOLDING TAX ON CONSULTANCY FEES

A. Legal or practical basis for withholding 12.5%

The proposal in the 1980 Budget for the introduction of withholding tax on consultancy and other similar fees was to the effect that it would be at the rate of 20% of gross for residents and 25% of gross for non-residents. However, it would appear that in practice what is being withheld for the time being is 12.5%. This has worried the minds of many consultants as the legality of a withholding tax of 12.5% is questionable in view of the fact that the proposal in the 1980 Budget for a withholding tax on consultancy fees is not known to have been passed into law yet. As would have been expected, the proposals would, where appropriate, be embodied in the 1980 Finance Bill with retroactive effect from 1 April 1980.

For all practical purposes, it could be deduced that the idea of withholding tax on consultancy fees seems to be borrowed from the 1980 Budget proposals. However, there is no intention to operate the proposal as if it is already law – otherwise the tax withheld could have been at the rate of either 20% or 25% whichever is applicable. Instead, 12.5% is being withheld.

What then is the legal basis for withholding 12.5%? Strictly speaking, there seems to be none yet. From experience, withholding tax on consultancy fees may eventually become law with a retrospective effect. This notwithstanding, the Revenue does not consider it appropriate to deduct 20% or 25%, as the case may be, as was proposed in the Budget statement. In retrospect, 12.5% appears to be a fair compromise figure which corresponds with the earlier withholding taxes introduced by the Federal Government.[14] Therefore, the working basis of 12.5% on consultancy fees seems to have been borrowed from the withholding taxes introduced earlier.

B. Rationality of basing withholding tax on gross fees

It is clear from Sections 8(1) and 11 that the basis of assessment of income of a company accruing in, derived from, brought into, or received in Nigeria in respect of trade or business, rent, dividends, fees, dues, etc. shall be profit.[15] This is not only reasonable but it is also in accordance with the usual practice. Only profit or its equivalent should attract tax. Nobody should expect a business entity to pay tax on a loss or expense.

In the case of consultancy fee, "contract fee" is not necessarily identical with "profit" except where there are no operating expenses, or where such operating expenses were provided for before arriving at the "contract fee".

However, the 1980 Budget proposal specifically based the withholding tax on consultancy and other similar fees on gross[16] and not net. The same is true of the earlier withholding tax on rent paid by companies.

It appears, therefore, on the face of it, that there is an obvious conflict between the provisions of Sections 8 and 11 of CITA 1979 which is clear on the issue of basing assessment on profits on the one hand, and the 1980 Budget Statement, on the the other hand, which bases the tax withheld on consultancy fees on gross.

C. Withholding tax versus final tax

However, there is a distinction between a withholding tax and a final tax. Withholding tax is in this context a portion of the gross fee withheld as partial payment of tax. It represents only a working basis for determining the actual and final tax payable. Therefore, since the deduction on the gross consultancy fee is only a withholding tax, it may not be right to assume that the final tax when it is determined shall not be based on the profit.

From the nature of consultancy services, instalment payments or remittances (in the case of foreign-based companies) are usually made as the work progresses. Tax on these instalment payments or remittances based on the deemed profit margin on the contract is withheld to meet the tax liability when this is finally determined.

The income statement of the company which is supposed to show the net profit which, after necessary adjustments for tax purposes, will form the basis for the assessment of the company may not have been prepared or presented at the time of the instalment payment or remittance when the tax is withheld. Yet tax has to be withheld on some rational basis at the time of payments and remittances. The most obvious and rational base, and the one which is independently measurable and verifiable at the time the payments and remittances are effected (in the absence of an income statement), is the agreed gross contract fee, reflecting, as much as possible, the deemed profit margin on the gross fee. Any other base may be purely arbitrary and unscientific.

Unless deductions are made by way of withholding tax from payments and remittances, it may be possible that by the time the accounts are presented for the final computation of tax liability, the company may have paid and remitted away part of its tax. Governments usually find it more convenient to owe than to be owed. Therefore, the Government will prefer to refund or credit a company for any excessive tax withheld than to become the creditor of the company for any underdeduction.

Since the tax deducted is only a withholding tax, the final tax to be paid when it is computed may be lower or higher than the withholding tax. This is because the final tax will be based, not on the deemed profit margin on the gross contract fee, but on the actual profit arising from the contract executed.

IV. CONCLUSION

Taxation of consultancy fees is not an entirely new phenomenon in Nigeria. It is covered under Sections 8

14. For instance, 12.5% withholding tax on gross rents paid by companies was introduced in 1979-80 and a withholding tax of 12.5% on dividends paid to shareholders was introduced in 1978-79.
15. Profits may be defined as the return received on a business undertaking after all operating expenses have been met (ibid., American Heritage Dictionary, p. 1045). By implication, profit here is taken to mean net profit and not gross profit.
16. Gross implies exclusive of deductions for expenses; i.e. total or entire fee, unmitigated in any way.

and 11 of the CITA 1979. The only new dimension to it is the proposal in the 1980 Budget Statement that deduction of tax at source or withholding tax is to apply to interest, rents, royalties, management and consultancy fees and such similar fees. These provisions in the Budget Statement are expected to be passed into law with retrospective effect to 1 April 1980. Hence Revenue is applying the principle of withholding tax on consultancy and such similar fees only in the spirit of the new proposal pending the passing of appropriate legislation.

Withholding tax which is based on the deemed profit on the gross fee is not to be mistaken for the final tax which should be based on the profit of the contract executed.

The former is only an interim measure, a temporary surrogate tax withheld from instalment payments and remittances of the agreed contract fee. When the final tax is determined, it will reflect the necessary adjustments for any under or over deduction of this tax at source. The idea of withholding tax on consultancy and such similar fees is a welcome development which, while safeguarding the interest of the Revenue, does not place the taxpayer at a long run disadvantage.

Confederation of British Industry supports new drive against unitary tax

The Confederation of British Industry is supporting a new drive against American tax laws which are penalising the US operations of British and European-owned multi-national companies. In a move involving the American Supreme Court, the CBI, with other European employers' organisations, is arguing that some of the tax laws enforced by a number of States, including California, Oregon, Alaska and Illinois, infringe the US constitution. The Supreme Court will shortly be asked for a decision.

The challenge which has been mounted concerns "unitary taxation", a system under which a company's tax liability is calculated not on local operations alone, but on a proportion of the world-wide profits of the entire group to which it belongs.

Mr. Bryan Rigby, Deputy Director General of the CBI said today: "Our decision to give our full backing to the statement which has been lodged with the Supreme Court by the Union des Industries de la Communauté Européenne (UNICE) – the confederation of our European sister organisations – is the latest move in the battle over unitary taxation, in which we have now been involved for five years. Our case has the support of the British Government, the European Community, and the US Federal Government."

He said: "We have always argued that unitary taxation is a particularly obnoxious levy. It means some companies will be taxed twice for the same operation. At least 50 British companies with household names – including British American Tobacco, Cadbury Schweppes, Imperial Chemical Industries, Reckitt & Coleman and Unilever – are involved, as well as dozens of French, German, Italian, Dutch and other European multinationals."

Mr. Rigby added: "Not only does it result in multiple taxation. It undermines the arrangements which have been painstakingly built up between governments over the years, specifically to avoid this injustice."

See in this respect: "Identification of the source of income – The unitary system of taxation" by James C. Redmond and the opinion of the Netherlands Federation of Employers VNO and NCW on the unitary system in 35 *Bulletin for International Fiscal Documentation* No. 3/1981 at 99 and 107 as well as "The potential dangerous effect upon international commerce of the "global" or "unitary" basis of assessment", document in which the ICC sets forth its opinion on the unitary system of taxation in 35 *Bulletin for International Fiscal Documentation* No. 4/1981 at 170.

Offshore Petroleum

Rules of the Ministry of Finance and the General Administration of Customs Concerning the Levy and Exemption of Customs Duties and Consolidated Industrial and Commercial Tax on Imports and Exports for the Chinese-Foreign Cooperative Exploitation of Offshore Petroleum *

(Approved on 28 February 1982 by the State Council, promulgated on 1 April 1982 by the General Administration of Customs and the Ministry of Finance)

In order to encourage Chinese-foreign cooperative exploitation of offshore petroleum, rules for the levy and exemption of customs duties and the consolidated industrial and commercial tax on imports and exports for offshore petroleum exploitation are hereby drawn up as follows:

Article I. The following imported goods shall be exempt from duties and the tax:
1. Machinery, equipment, spare parts and materials verified and approved for direct use in exploration.
2. Machinery, equipment, spare parts and materials verified and approved as necessary imports for direct use in development, in accordance with Article 19 to Article 21 of the "Regulations of the People's Republic of China on the Exploitation of Offshore Petroleum Resources in Cooperation with Foreign Enterprises".
3. Parts, components and materials verified and approved as necessary imports for manufacturing machinery and equipment in China for the exploitation of offshore petroleum (including prospecting, well drilling, well cementing, well logging, mud logging, oil production, work-over, etc.).
4. Machinery and other engineering equipment, temporarily imported for exploitation of petroleum and guaranteed to be re-exported by foreign contractors, shall be exempt from the duties and the tax when imported or re-exported.

Article II. Crude oil received by foreign contractors in accordance with provisions of the petroleum contracts shall be exempt from export duties when it is exported.

Article III. Customs duties and consolidated industrial and commercial tax shall be levied on imports and exports beyond the scope specified in Article I and Article II above according to The Customs Import and Export Tariff of the People's Republic of China and the Regulations of the Consolidated Industrial and Commercial Tax of the People's Republic of China (Draft).

Article IV. All goods imported free of the duties and the tax shall not be used for other purposes without Customs' approval. Breaching of these rules shall be dealt with by the Customs in accordance with "The Provisional Customs Law of the People's Republic of China".

Annex: List of Imported Goods Exempt from the Duties and the Tax for the Chinese-Foreign Cooperative Exploitation of Offshore Petroleum

I. Goods verified and approved as necessary imports for direct use in exploration:

A. For geophysical exploration:
1. Ships for geophysical exploration and accessory equipment thereof.
2. Seismographs, components and accessories thereof, gravimeters and magnetometers and accessories thereof.
3. Hydrophone streamers and accessory equipment thereof.
4. Data processing computers and accessory equipment thereof.
5. Seismic tapes.
6. On-land navigation and positioning equipment and accessory facilities thereof.

B. For well drilling:
1. Various offshore drilling installations, including jack-ups and semisubmersible drilling rigs, floating drilling ships and drilling platforms as well as tender ships, working boats and service vessels.
2. Drilling rigs, and components, accessories or fittings thereof.
3. Well cementing equipment and auxiliary equipment, including cement mixer and feeding equipment.
4. Well logging equipment and auxiliary equipment including electrical logging instrument, mud logging instrument, directional survey instrument and other logging instrument.
5. Production testing equipment, work-over equipment, and components or accessories thereof.
6. Special tools for well drilling, including drilling bits, drill collars, drill pipes, deviation control tools, fishing tools and other tools.
7. Drilling mud treating equipment and chemicals.
8. Materials used exclusively for oil wells, including tubing, casing, wellhead equipment and subsea equipment and tools.
9. Oil well cements and various additives.

C. For safety and lifesaving:
1. Various kinds of equipment, spare parts and materials for blowout prevention.
2. Various kinds of equipment and materials for fire prevention and fire fighting.
3. Various kinds of equipment, accessories and tools for lifesaving.
4. Special labor protection outfits for personnel working offshore.
5. Equipment and materials for diving operations.

D. For transportation and communications:
1. Helicopters and facilities for helipad.
2. Vessels for transportation, communications and convoy, and accessory equipment therefor.
3. Various kinds of equipment and outfits for wire and radio communication.

* Unofficial translation.

E. For fuels and oils:
Special fuels, lubricating oils and cooling fluids necessary for offshore petroleum operations.

II. Goods verified and approved as necessary imports for development, or, oil field construction:

A. For oil production:
1. Production platforms, including oil production platforms, oil-gas processing platforms, living platforms and flare platforms.
2. Offshore oil loading facilities, including single-point mooring, single articulated leg mooring, oil storage vessels, under-water oil storages and loading berths.
3. Vessels for offshore construction operations.
4. Power generating equipment and accessories thereof, including internal-combustion engines, steam turbines, gas turbines, steam engines, generators and electric motors as well as controlling panels and related installation.
5. Injection equipment and accessories thereof, including water and gas injection as well as facilities for water and gas treatment.
6. Downhole packers and downhole blowout preventors.
7. Cranes, lifting equipment and tools.
8. Oil (gas) transportation equipment, line pipes, and valves and pipe fittings thereof, equipment for pumping and boosting stations and onshore terminal, and valves and pipe fittings thereof, including various kinds of pumps, equipment for liquid separating, heat-exchanging, purifying, and compressing, various kinds of measuring, monitoring and parameter indicating meters, and various kinds of valves and pipe fittings thereof, various kinds of electric instruments and cables.

B. For automation, remote controlling and telemetering:
1. Various kinds of installation and meters.
2. Air-conditioning equipment.

III. Parts, components and materials verrified and approved as necessary imports for manufacturing equipment and machinery in China for the exploitation of offshore petroleum.

IV. The importation of the above-mentioned goods shall be subject to the verification and approval of the Ministry of Petroleum Industry.

LATIN AMERICA

New statute for Andean multinational enterprises introduced

by Pedro Massone

The Commission of the Cartagena Agreement (Andean Group) approved Decision 169 of 1982 containing a statute for Andean Multinational Enterprises (Empresa Multinacional Andina – EMA).

EMAs are enterprises which comply with the following conditions:
(1) have their domicile in a member country;
(2) at least 80% of their capital belongs to national investors from 2 or more member countries (for 10 years the percentage is 60% for Bolivia and Ecuador);
(3) investors from the country where the principal domicile of the EMA is located hold at least 15% of the capital; the same condition is to be complied with as regards investors from at least one other member country;
(4) the majority of Andean capital is reflected in the technical, administrative, financial and commercial control of the EMA; and
(5) the EMA is organized as a corporation and its capital is represented by registered shares bearing equal rights and charges.

EMAs can be established by the creation of a new corporation or by the reorganization of an old enterprise. They are subject to the law of the country where they have their principal domicile and are additionally registered with the Junta of the Andean Group.

EMAs organized under Decision 169 shall enjoy the following benefits:
(1) the advantages of the Andean liberalization program;
(2) the same treatment applicable to national enterprises performing the same economic activities, as regards internal taxes;
(3) access to local credit and financial transactions under the same rules applicable to national enterprises performing the same economic activities;
(4) exemption from authorization requirements for investments and reinvestments to be carried out in the country where the EMA has its principal domicile. Reinvestments are subject to registration. If the investment is carried out in a member country other than that where the EMA has its principal domicile, the investment is subject to registration; moreover, authorization from the recipient country is needed in order to participate in economic sectors reserved to national investors;
(5) the right to establish branches in any member country and to transfer full net profits of those branches to the EMA's head office in foreign currency and with the authorization of the competent authority (this means that the percentage limit established in Article 37 of Decision 24 does not apply);
(6) the right to transfer abroad, in foreign currency and with the authorization of the competent authority, the entire profits of the EMA belonging to foreign or to subregional investors (this means that the percentage limit established in Article 37 of Decision 24 does not apply);
(7) avoidance of double taxation of income, under the following rules:
   – dividends paid by the EMA out of profits previously taxed in the member country where the EMA has a branch shall be exempt in the country where the EMA has its principal domicile. Subsequent redistribution made by the investor enterprises (i.e. EMA shareholders) out of the same dividends shall also be exempt as aforesaid; and
   – income representing redistributions made by investor enterprises (i.e. EMA shareholders) out of dividends received from EMAs which have previously been taxed shall be exempt in other member countries.

Decision 169 shall enter into force upon the deposit of the instruments of ratification by two countries.

Decision 169 does not revoke the old statute contained in Decision 46 and once Decision 169 enters into force it will be possible to organize EMAs under either of the statutes. The possibility of benefiting from both statutes simultaneously is excluded and it can be expected that the new statute will be preferred.

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Monograph dealing with the law concerning representative agents in Saudi Arabia. English texts of relative laws thereto are appended.
(B. 51.915)

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Financial institutions in Hong Kong: A reappraisal

By I.W. Harris*

The 1982 Budget introduced by Hong Kong's new Financial Secretary Mr. John Bremridge earlier this year, in February, contained two further major proposals concerning the taxation of interest in Hong Kong. However, before detailing these proposed amendments to the Inland Revenue Ordinance it may be worthwhile to spend some little time, for those who are not familiar with the law, on the history of the taxation of interest in general in Hong Kong and the 1978 amendment in particular.

Hong Kong's tax legislation was introduced in 1947 and was based on the schedular system whereby income from "profits", "salaries", "property" and "interest" was all separately assessed. This departure from the normal full income tax system was due in the main to the local population's traditional opposition to the powers of Governments to probe into personal wealth. A further fundamental concept of the legislation is that it is territorial in nature and thus only seeks to bring into the charge income "arising in or derived from" Hong Kong. Over the years, Hong Kong has grown considerable, not only in terms of population from approximately 1.8 million in 1947 to over 5 million at present, but also in the nature of its trade. In 1947 Hong Kong was struggling to pick up the pieces after the Second World War and to establish itself once again as a premier port in the region, but successive waves of immigration from China not only had the effect of increasing the population but also brought in new skills, particularly the textile manufacturers who had come from Shanghai. Thus Hong Kong's role as an entrepot changed over the years until by the 1960's Hong Kong had emerged as a major manufacturing and trading nation and now ranks among the top 20 in the non-oil producing world. The expansion of the manufacturing sector necessitated a parallel expansion in the financial sector to finance trade and the necessary infrastructure. This vigorous growth coupled with the Hong Kong Government's traditional policy of laissez faire – including a benign tax law as to both its scope (territorial) and rates (from a standard rate of 10% in 1947 to 15% in 1966 and the present corporate tax rate of 16½% – led to Hong Kong becoming what is now considered the third most important financial centre in the world after London and New York.

With the rise in importance of Hong Kong as a financial centre, the importance of interest tax increased with collections rising from HK$ 3M in 1951/52 to HK$ 540M in 1980/81 and thus this is perhaps an opportune moment to stress the practical effect of Hong Kong's schedular system. Although perhaps roughly modelled on the U.K. Schedules contained in the Income and Corporation Taxes Act 1970, the Hong Kong system does, however, give rise to confusion in the minds of many, even in Hong Kong. Thus there is no full income tax in Hong Kong and only in certain restricted instances is a person required to complete one tax return showing all his income from, say, a business, a salary from an employer, rent from a property and interest on a fixed deposit. Instead, each source is assessed separately and different rules apply in relation to each of the 4 schedules. Interest tax is levied at the standard rate "on the recipient of any sum paid or credited to him in that year being (a) interest arising in or derived from the Colony . . ."[1] However, although the interest tax is a tax on the lender, the tax itself is paid by the borrower, ". . . at the time he makes the payment or credit".[2] There are a number of exemptions from interest tax, the 2 most important of which for the purposes of this article are (a) interest paid by banks or public utilities at, or lower than, what is generally known as the savings bank rate and, more importantly, (b) interest paid *to* a bank carrying on business in Hong Kong. Thus banks are exempt from interest tax but, of course, are liable to Profits Tax at the rate of 16½%, which I shall discuss in more detail below. Before leaving interest tax, mention must be made as to what determines whether interest arises in or is derived from Hong Kong. After years of uncertainty the Inland Revenue Department issued guidelines in 1978[3] which laid down that the true test was where the provision of credit was made available to the borrower. The Revenue's support for this view was obtained from a number of Commonwealth tax cases including CIR v. Philips[4] and CIR v. Lever Brothers[5].

We turn now to the Profits Tax which is levied on "every person carrying on a trade, profession or business on the Colony in respect of his assessable profits arising in or derived from the Colony . . .".[6] Assessable profits are defined as "profits in respect of which a person is chargeable to tax . . .".[7] The test for what profits are subject to Hong Kong tax is based on 2 Hong Kong court decisions in the Hong Kong and Whampoa Dock[8] and International Wood Products[9] cases, giving rise to what is known

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1. Inland Revenue Ordinance, Section 28 (1)(a).
2. Id., Section 29 (1).
3. Departmental Interpretation of Practice Notes No. 13.
4. Commissioner of Inland Revenue (NZ) v. NV Philips Gloeilampenfabrieken, 10 ATD 435.
5. CIR v. Lever Brothers and Unilever Limited (1946) 14 SATC 1.
6. Inland Revenue Ordinance, Section 14.
7. Id., Section 2.
8. HKTC 85.
9. HKTC 551.

as the "operations test". In other words, this test relies on the fact that the source is determined where the majority of the actions leading to the profit actually took place, which of course is very different from the test used for interest tax purposes. It may be easier for the reader to understand the "operations test" principle by a brief discussion of the 2 cases referred to above.

The Dock case concerned a salvage operation in the South China Sea many miles from Hong Kong which was where the company was incorporated and carried on its business. Although much of the initial work, including the contract concerning the salvage operation, was carried out in Hong Kong, nothing would have been earned if the rescue tug had not gone to sea to perform the actual operation. The Court held, therefore, that the profit was earned outside of Hong Kong.

In the Wood Products case the company acted as agent in Hong Kong for 2 companies in the Philippines for the sale of timber. The company appointed sub-agents outside of Hong Kong who sent orders direct to the principals, payment being made direct in most cases. The company received commission and passed on sub-commission and the Court agreed that the "operations test" applied and that the commission did not arise from the carrying on of a business in Hong Kong but as a result of the efforts of the sub-agents of Hong Kong.

Although the tax legislation was very productive of Revenue with yields from the Earnings and Profits Tax rising from HK$ 154 million in the year ended 31 March 1961 to HK$ 778 million in the year ended 31 March 1971 and to HK$ 7,964 million in the year ended 31 March 1981[10], it became clear that there was a need to step back and look at the position in the light of the current trading and economic situation in Hong Kong. Thus in 1976 the Third Inland Revenue Ordinance Review Committee (TIROC) was formed by the Government to "consider the present system of taxation of profits and other forms of income contained in the Inland Revenue Ordinance, and in particular:

. . .

d. the treatment of interest and the relief for interest paid;
e. the territorial ambit of the various charges (having regard, inter alia, to the effects of changing commercial practices and recent case law; . . ."[11]

The Committee issued its report in December 1976 and amongst its many recommendations was one that questioned the application of the territorial source concept as it related to financial institutions. The Committee felt in respect of offshore interest, i.e. interest arising outside of Hong Kong, that, ". . . the temporary reinvestment of money which a depositor places for the time being in the hands of a financial institution is one of the central activities of the institution's business . . .".[12] Thus the Committee argued the interest actually arose in or from Hong Kong and should be assessed accordingly.

To the financial institutions in Hong Kong this proposal came as an unprecedented move. The draft legislation was published as a Bill in March 1978 the main thrust of which was to add a further deeming clause to Section 12 of the Ordinance in the following terms:

(i) sums not otherwise chargeable to tax under this Part, received by or accrued to a bank or other financial institution by way of interest which arises directly or indirectly through or from the carrying on by the Bank or other financial institution of its business in the Colony, notwithstanding that the moneys in respect of which the interest is received or accrues are made available outside the Colony."

In addition, there were definitions of "financial institution" and for the purposes of this definition "associated corporation" was also defined. for those used to the convoluted and lengthy wording of the Australian, United Kingdom or U.S.A. tax acts, the length of the new legislation was perhaps surprisingly short. However, despite Hong Kong's importance as a financial centre and a major trading nation, the Inland Revenue Ordinance still contains only 88 sections and 4 very short shedules.

There followed a series of attacks both in the Legislative Council (Parliament) and in the press with the main focus being on the legislation's discriminatory nature and the apparent abandonment of Hong Kong's territorial source concept of tax legislation and its retrospective effect. In defending the proposals in the Legislative Council, the then Financial secretary, Sir Philip Haddon-Cave, said on 12 April 1978 that, "when a bank or a financial institution obtains funds, whether locally or abroad, through its operations in Hong Kong and places the funds abroad to earn interest, the profits from such interest will be taxed irrespective of the provision of credit test. To determine whether interest on a loan arises, directly or indirectly, through or from the carrying on of business in Hong Kong will require an examination of the totality of the circumstances relating to where and how the deposits are garnered and the funds on-lent. In most cases, the determination will be relatively straightforward, but in the case of some lare foreign currency loans problems may arise". He went on to say that there were a number of misconceptions in that, "it has been suggested that tax will be charged even where the role of the Hong Kong end of the business is negligible (for example, where it does little more than make certain book entries, commonly known as "book" or "garaging"). In these circumstances, the interest clearly could not be said to have arisen in Hong Kong". The Financial Secretary said that another misconception was that, "it has been suggested that the Bill fails to reflect the recommendation of the Review Committee in that, as drafted, it has the effect of bringing to charge a wider range of profits than was envisaged by the Review Committee and that the Bill should only seek to bring to charge profits derived "without the substantial intervention of a branch elsewhere". This is an expression used by the Review Committee to describe profits which it considers should be taxed, but, "if it is shown, on the facts of a particular case, that the profits from interest arise partly from the business in Hong Kong and partly from the substantial intervention of an overseas branch, a reasonable apportionment of the profits will have to be made". As regards the territorial source concept, Sir Philip said it

10. Annual Reports of the Commissioner of Inland Revenue.
11. TIROC, Para 1.
12. TIROC, Para 132.

was not true that a change had been made from a source to a residence basis and said that, "where a business is carried on in Hong Kong and the profits of that business arise in Hong Kong, such profits clearly have a territorial connection with Hong Kong. However, because case law has established that artificial provision of credit test, some profits from interest have been escaping the charge to tax. The Bill does no more than correct this situation, but is does so by reference to business activities carried on here, and *not* by any arbitrary test related to residence".

On 16 August 1978 when the debate on the Bill was resumed, the Financial Secretary once again defended the Bill against its critics but he did however concede some points to the opposition, including:

(a) an amendment to the definition of "financial institutions"; and
(b) the delection of the words "directly or indirectly" from the main body of the amendments and thus the final version read as follows:
"(i) sums, not otherwise chargeable to tax under this Part, received by or accrued to a financial institution by way of interest which arises through or from the carrying on by the financial institution of its business in the Colony, notwithstanding that the moneys in respect of which the interest is received or accrues are made avaible outside the colony".

For most financial institutions the legislation was retrospective as it became effective as from 1 April 1978 in as much as the majority of them had financial years ending on 31 December or 31 March and thus had already earned profits prior to the passing of the amendment. The attention of the financial community then turned to the Inland Revenue Department in an attempt to obtain some comfort that the soothing statements of the Financial Secretary would be translated into practice by the Revenue despite the somewhat tougher stance reflected in the actual wording of the law. The Revenue did issue a Practice Note which, however, did little to clarify the position and did little else other than asking that the full facts should be disclosed in all cases. This attitude failed to mollify the critics or allay their fears although some commentators including the writer considered that the Revenue would take a reasonable attitude.

And so it turned out to be. Certainly the suggestion made in some quarters that the introduction of the legislation would mean a mass exodus of financial institutions to other centres did not take place. In fact, when the then current moratorium on bank licences was lifted in May 1981, a new surge of international banks arrived on the local scene. The first returns under the new legislation were not submitted until the middle of 1979, and not unnaturally it was some time before any pattern emerged from the Revenue. The Revenue's initial efforts appeared to be merely detailed requests for more information which some tax advisers considered unreasonable and unnecessary, but it was perhaps inevitable that the Revenue were almost as unsure as to how to interpret the new law as the tax advisers. In mid-1981, a change of personnel in the Revenue Department marked, some considered, a change of emphasis although it is probably fairer to say that the fact gathering stage had been completed an the Revenue were now able to issue assessments based on the new law. By the end of 1981, final assessments were being issued and initial indications were that the Revenue were indeed taking a reasonable attitude. One perhaps surprising development was, however, that the question of any apportionment had rarely been considered and what the Revenue was saying in effect was that either the interest was wholly from Hong Kong or wholly from outside, each case being decided on the weight of the facts. This at least avoided taxation problems and was generally welcomed by the financial institutions. In certain circumstances, however, where the Revenue considered that interest arose in Hong Kong, they were prepared to accept an apportionment where there had been a substantial intervention by a branch. A further concession readily accepted by the Revenue was that although the Financial Secretary had referred to the substantial intervention of a "branch", this was extended to include a company. Although most banks operating in Hong Kong operate through a branch, most deposit taking companies operate through a branch, most deposit taking companies operate through a subsidiary.

In the meantime, however, a further piece of legislation was enacted to counter an avoidance device that had been exploited by certain financial institutions. As can be seen from the wording of Section 15(1)(i) quoted above, only so-called offshore interest had been brought into the net. What a number of financial institutions had been tempted to do was to convert interest into discount by offering Certificates of Deposit and other similar instruments generally in U.S. dollars which, provided they were redeemed prior to maturity, did not give rise to any interest payment. Therefore they claimed that the profit was exempt from profits tax. In the writer's opinion, however, some of the schemes offered could have been caught by the existing legislation but nevertheless the Revenue, not unsurprisingly, moved to counteract such blatant avoidance devices and a Bill was introduced into the Legislative Council as a result of the 1980 budget speech. The effect to the proposed amendment was to bring in yet another deeming provision in Section 15(1)(j) which sought to close the 2 loopholes in the previous law:

(a) the disposal by individuals and corporations of Certificates of Deposits prior to maturity whereby the profit received is not interest but a profit on sale of a security which is not taxable unless of course the taxpayer was a dealer in securities;
(b) the purchase of bills of exchange and other similar instruments at a discount and the redemption thereof at face value which, again, if held by persons who were not dealers in securities would not be subject to tax.

It should be noted that there was no mention of the currency of the "instrument" in the law and therefore, although clearly Hong Kong dollar denominated Certificates of Deposits and Bills of Exchange came within the net, those denominated in foreign currency would only be brought in if the provision of credit test showed that the deemed interest had a Hong Kong source. The Bill became law on 28 May 1981 and was operative with effect from 1 April 1981.

We now come to the 1982 amendments. Despite the number of international banks operating in Hong Kong, many bankers considered that Hong Kong's claim to be a major financial centre still had one major drawback: the interest withholding tax. This was despite the fact that it was relatively simple to avoid Hong Kong withholding tax by ensuring that the provision of credit was made abroad. This enabled Hong Kong depositors to place funds with offshore branches of local banks without incurring any interest tax liability and enabled Hong Kong businesses to borrow funds without the need to withhold tax. The Hong Kong Association of Banks made a submission to the new Financial Secretary, Mr. John Bremridge, and he was persuaded to abolish the withholding tax on foreign currency deposits. This meant that Hong Kong banks were able to accept foreign currency deposits. Under the previous system such deposits would have been booked in offshore banks such as Singapore, Bahrain, Jersey or Nassau. This may have been good news for depositors, but for Hong Kong based banks it meant that the profits earned on such deposits now came within the Hong Kong profits tax net. As a follow-up measure to the abolition of interest tax on foreign currency deposits, the Financial Secretary reduced the standard rate on Hong Kong dollar deposits from 15% to 10%. He said in so doing that unless such a measure was taken it would provide an encouragement for all Hong Kong depositors to switch from Hong Kong dollars to foreign currency with the resultant effect in exchange rates. He considered a 10% rate sufficient to retain Hong Kong deposits without incurring exchange risks.

So this is the position in the middle of 1982 – much has changed in the past 4 years, but it is probably fair to say that on the whole it has been for the good of Hong Kong although individual bankers facing increased tax assessments can hardly be expected to accept this position. The final story on Section 15(1)(i) has still to be written, but at least it can be said that the worst fears of bankers have not materialised, but it will not be until one or more cases come to the Courts, as undoubtedly they will, that the final chapter will be written.

BERMUDA:

Fiscal Structure of a Low Tax Country

By H.W.T. Pepper

The article under this title in the August/September 1982 issue described the Fiscal system in Bermuda. The author wishes to give further elucidation and updating.

Condominiums and time-sharing tax – service tax (P. 406, left column, last para). While Time-Sharing has given scope for sharp practice in some countries, in Bermuda all payments must *initially* go into escrow and then a Trust Fund is set up to protect the interests of investors.

Transportation Taxes (P. 406). The 1982/83 Budget increased the license fees for Motor cars, Commercial Vehicles, and motor cycles and motorised bicycles, respectively from $ 80 to $ 265, $ 175 to $ 1320, and $ 9 to $ 45.

Land Tax (P. 407). The second sentence of the second paragraph dealing with the *Basis of Valuation* should read "Rent control applies to residential units with an ARV of $ 7,500 or less but the land tax payable is taken into account in fixing the controlled rent". The second sentence under the heading *Dates of Payment* should read, "A person who wishes to register a motor car must, when applying, quote the street name and house number or valuation number of his residence. This requirement helps to enforce the rule that there may be only one motor-car per household". The first sentence under *Rates of Tax* should read "Properties with ARV's up to $ 2220 pay tax at 3% and the rates graduate to a maximum of 20%.

The *Transfer tax* (p. 407 last paragraph) of 10% on non-Bermudians referred to under sub-paragraph 2 is regarded as a licence fee.

Stamp Duties (P. 408 first entry) the rate of 0.25% applies to all items mentioned in the second paragraph.

Property Taxes in the Caribbean Community

by George E. Lent

Caribbean states that now compise the Caribbean Community (CARICOM)[1] provide an interesting study in the diversity of annual taxes on real property. A number of significant features emerge in this comparative study:

(1) All but a few of the states continue to levy rates based on the annual value system implanted by the British.
(2) Several governments have extended what is traditionally a tax on urban buildings to cover agricultural and urban land as well.
(3) Extensive cadastral surveys have been undertaken in many of the islands, some strictly for legal registry of land, others expressly for land tax purposes.
(4) Because of generally low rates, undervaluation and tax relief, property taxes have failed to realize their revenue potential.
(5) In no state does the annual tax on real estate make an important contribution to government revenue.

It is hoped that this survey will point the way to a more rational system of property taxes in this part of the world that will improve their economic and administrative efficiency and enhance revenue.

1. DIVERSITY OF THE TAX BASE

The British rating system, based on the annual rental value of buildings, provided a simple model for transplanting to the West Indian colonies. Similar systems, sometimes called a land or house tax, continue to be in effect in all but a few of these countries and territories. Barbados, Grenada, and Jamaica have replaced rental value and other rates by taxes based on the market value of land or of land and improvements;

Trinidad and Tobago had planned as early as 1962 to replace the annual value system with a modified site value tax but finally, in 1973, decided to retain annual value rating.

Jamaica was the first to rationalize its property tax system when in 1901 it replaced its quit rent based on acreage, a house tax based on annual rental value, and a graduated holdings tax with a tax based on the market value of land and improvements (capital value).[2] Tax was assessed on the value of property declared by landowners (so-called ingivings), which was updated in 1911, 1929 and 1937. By 1943 the chaotic state of the self-assessed property tax led to the appointment of a Commission of Inquiry under the chairmanship of Simon Bloomberg. The Commission recommended replacement of the capital value tax by a tax based on unimproved land value, also to be self-assessed. Work on the project was initiated in 1949 and revived in 1951 but was finally suspended because of the lack of maps and other resources. The unimproved land value principle was challenged in 1954 by the British economists Ursula F. and John R. Hicks who, in a broader study of Jamaica's finances, recommended revitalization of the capital value approach.[3] The issue finally was resolved in favor of unimproved land value when in 1956 a United Nations adviser, J.F.N. Murray, strongly supported it.[4] This concept was incorporated in Jamaica's Land Valuation Act which became effective in January 1957. The first 7 parishes were brought under the new law between 1959 and 1965, but with a change in government in 1962 work on the cadastral survey was suspended and was not resumed until 1972. The important urban parishes of Kingston and St. Andrew were then assessed and the old system finally phased out in 1974. During this period of 15 years, the new and old rating systems existed side by side.

Barbados had long imposed a tax based on annual ratable values when in 1969, following the recommendation of a United Nations report in 1963, it enacted a Land Valuation Act preparatory to introducing a tax based on unimproved land value. After completion of a cadastral survey in early 1973 and enactment of the Land Tax Act, rates under the new law were levied for the fiscal year 1972/73. In 1975, however, the site value system was modified to include tax on improvements with a value in excess of BDS\$10,000 (1 BDS\$ = U.S.\$0.50).

As was indicated above, Trinidad and Tobago introduced a project to replace its annual value system with a modified site value tax.[5] The Valuation Land Act was approved in 1969 and the cadastral survey of the entire country was completed early in 1973. Despite plans to introduce property tax legislation in 1973 that would include a levy on land and the value of improvements exceeding a specified ratio to the site value, vigorous protests in the capital against earlier increases in the house tax deterred action. Sharp increases in the price of oil, produced domestically, then made higher taxes unnecessary, so that Trinidad and Tobago has never replaced its house tax based on annual rental values.

In 1965 Montserrat initiated a series of property tax reforms with replacement of its acreage tax by an annual value system at a rate of 5%.[6] This was revised in 1967 by adoption of a modified site value tax, but the form of annual value rating was retained by converting the market value of land to annual values, first at 15% and later (1974) at 20%. Buildings were taxed only when 5 or 6%

1. Included are: Antigua-Barbuda, Belize, Barbados, Dominica, Grenada, Guyana, Jamaica, Montserrat, St. Kitts-Nevis-Anguilla, St. Lucia, St. Vincent and Grenadines, Trinidad and Tobago. Also referred to are certain British dependencies in the Caribbean: Cayman Islands, British Virgin Islands, Turks and Caicos.
2. For a brief account, see O. St. Clare Risden, "A History of Jamaica's Experience with Site Value Taxation", in Roy W. Bahl, editor, *The Taxation of Urban Property in Less Developed Countries* (Univ. of Wisconsin Press, Madison, Wis., 1979).
3. J.R. and U.K. Hicks, *Report on Finance and Taxation in Jamaica* (Kingston: Government of Jamaica, 1954).
4. J.F.N. Murray, *Report to the Government of Jamaica on Valuation, Land Taxation and Rating* (Kingston: Government of Jamaica, 1956).
5. Ralph A. Pierre, "Background to the New Rating System in Trinidad and Tobago", Third Regional Conference of Commonwealth Caribbean Tax Administration, Antigua, 1972 (mimeographed).
6. "Taxation of Land and Buildings in Montserrat", First Meeting on Property Tax Administration, Basseterre, St. Kitts-Nevis, 10-11 Nov. 1980 (mimeographed).

of the value of land and buildings exceeded 20% of the land value; the tax therefore fell most heavily on land. In 1974 graduated rates were introduced at 5% of the first $500 and 10% above that. By 1980 Montserrat considered abandoning its formal annual value structure in favor of modified site value tax which was believed to be more attractive from a rate point of view.

Grenada, in January 1982, was the latest of the Lesser Antilles to reform its annual value rating system. In March 1982 the Government announced a new rate structure based on the market value of land and improvements that were appraised by Government assessors the previous year.[7]

2. ROLE OF THE CADASTRE

Despite long established property taxes, in none of the 3 countries – Barbados, Jamaica, or Trinidad and Tobago – was there a complete official record of land holdings that would make it possible to identify their location, dimensions, and ownership. Indeed, there were no maps of the country that could be used to prepare a cadastre for tax purposes except in Trinidad and Tobago where local ward maps proved useful. Without extensive field work there would be no basis for determining the value of land parcels equitably, ensuring that all properties were covered, and identifying the persons liable for tax. The preparation of a cadastre was therefore indispensable to the administration and control of a national property tax.

It had long been believed that a cadastre of registered titles to land was essential for this purpose; in fact, proposals to introduce a general property tax in Jamaica before the turn of the century were frustrated by the great cost and time required for such a survey. Sir David Barbour, in his report, *Finances of Jamaica* (1899), stated:

> Until a cadastral survey of the Island has been made the assessment of the annual value of all land must be attended with much difficulty . . . . Such a survey was proposed, and strongly supported, in former years, but was ultimately dropped on the ground, apparently, of the cost involved in carrying it out.[8]

In embarking on the land tax projects in these 3 countries it was decided that a detailed cadastre that demarked boundaries and authenticated title was not essential for the proposed levy and would take undue time and cost to carry out. Something less definitive would serve the purpose; this is called a fiscal as distinguished from a legal cadastre.

The major stages in the process of preparing a fiscal cadastre include (1) mapping and editing, (2) referencing, and (3) market analysis and valuation.[9] Working from aerial photographs in Barbados and Jamaica, survey teams prepared valuation index maps (248 in Jamaica); on these maps were plotted the properties for which survey plans were available; missing areas were then filled in by surveys in the field. These maps served as the basis for the numerical referencing of all land parcels, each parcel being identified by map number, grid number, block number, and parcel number. The identification of ownership (or occupancy) and valuation of land was coordinated with the mapping. The Commissioner of Valuation was authorized to place on the roll as the taxpayer the person who on the best evidence available he believed to be the owner.

One of the advantages claimed for unimproved land value taxation is that mass valuation of properties is facilitated. Analysis of sales and other valuation data makes it possible to establish unit values which can be used to value parcels in different areas; weights can be assigned to different locational and physical characteristics of the land by multiple correlation techniques. Computer analysis of these factors in Trinidad and Tobago was based on a sample of 10,000 parcels; about 4,500 parcels were analyzed in Barbados.

Although the United Nations provided substantial support to these projects by underwriting the cost of administrative experts and equipment, the major cost was incurred by the countries themselves in the establishment of land valuation departments. Barbados had a staff of 42 persons, Trinidad and Tobago about 100 technicians and experts; the earlier (1952-62) staff of Jamaica totaled about 80 persons, and the later one (1972-74) about 150 persons.

Once a valuation staff was organized and trained and maps made available, the field work was completed fairly expeditiously. About 48,600 parcels in Barbados were identified, mapped, and valued over a period of about 2 years; in Jamaica 171,240 parcels were completed in 7 parishes over the 4-year period beginning in June 1957; and in Trinidad and Tobago about 160,000 parcels were valued within a period of about 2 years, 1971-73. It is noteworthy that all of these surveys turned up thousands of properties that were not previously on the tax roll. For example, Jamaica's earlier cadastre for 7 parishes included 23,800 parcels not taxed before – about 11.5% of the total. On the other hand, it was not possible to establish the ownership of land for many parcels, almost 10%, in Barbados.

Some indication of the quality of the undertaking is given by the record of objections to the assessed values. Over the entire project in Jamaica, owners of about 9% of the parcels filed objections; the ratio ran as high as 15% in the metropolitan area. This high ratio can be attributed in part to the substantial tax increase involved in most cases in the shift to the new site value tax as against previously self-assessed taxes.[10] This ratio contrasts with an objection rate of less than 3% in Barbados despite an average doubling of the tax on property. The experience of Trinidad and Tobago is moot because its proposed modified land value tax was never introduced.

In contrast to the fiscal cadastres completed in Barbados, Jamaica, and Trinidad and Tobago, legal cadastres have

7. *Barbados Advocate,* 29 March 1982.
8. Cited by Wilfred Chang, "Recent Experience of Establishing Land Value Taxation in Jamaica", in *International Seminar on Land Taxation, Land Tenure, and Land Reform in Developing Countries* (Hartford: The John C. Lincoln Institute, 1967).
9. See United Nations, *Manual of Land Tax Administration,* 1968, for an excellent exposition of the process.
10. Daniel M. Holland, "Jamaica and Barbados", in The Lincoln Institute of Land Policy, *Property Tax Reform,* Lincoln Institute Monograph No. 77-11, December 1977, p. 70.

been installed in several smaller islands of the eastern Caribbean with the technical assistance of the Directorate of Surveys of the British Overseas Ministry. These cadastres provide for registration of titles to land, hitherto incomplete, rather than as a basis for taxation. Additional steps therefore needed to be taken for the demarcation of boundaries and authentication of ownership before a certificate of title could be granted. The islands in which work was completed and the time period involved are the following: Turks and Caicos, 1968-72; British Virgin Islands, 1972-74; Cayman Islands, 1972-77; Anguilla, 1974-76; Antigua, 1975-80; and Montserrat, 1978-81.[11] The United Nations has drafted plans for a cadastral survey and land registration project for the Commonwealth of Dominica, but no action has been taken.

3. TAX RATES AND YIELDS

In one of the countries of the CARICOM do property taxes play an important revenue role. Jamaica's land taxes account for less than 4% of total tax revenue (3.6% in 1976/77); Barbados' modified land taxes contributed 3% of total tax revenue in 1980/81; Guyana's property tax amounted to 1% of tax revenue in 1978/79, and Trinidad and Tobago's to a miniscule one quarter of 1% in 1978/79. Of the smaller islands that comprise the Eastern Caribbean common market subregion, only Montserrat's system yielded as much as 5% of total revenue (Montserrat's population is about 12,000); in none of the others did property tax revenue exceed 1% of total revenue over the period 1975-1980.[12]

Realizing the revenue potential of a property tax is inhibited by the sensitive nature of a levy based on administrative assessment. Unlike an income tax or sales tax the payment of which generally reflects some measure of current taxpaying ability, a tax based on gross wealth is not well correlated with current income or liquid assets necessary to meet the payment. This fact places a certain political constraint both on tax rates and the tax base either through underassessment or special relief. It is also true, as in Trinidad and Tobago, that the availability of more important revenue sources relieves pressure on property taxes and they become neglected.

a. Tax rates

The negligible revenue of most of these countries with annual value taxes can be explained by the nominal rates of ½% to 1% that are in effect. Even rates of 7% to 9% that have been levied in Trinidad and Tobago have been unproductive by comparison with countries basing their tax on the value of land or land and improvements. Since capital value is some multiple of annual value, or yield, a multiple of, say, 5 would make an annual value rate of 1% equivalent to only 0.2% of capital value. Such a low capital value rate is rarely found. Montserrat beginning in 1967 calculated the annual value of land at 15% of its market value, and beginning in 1974 at 20%; its 5-10% annual value rate therefore was equivalent to 1-2% of land value – a level of rates found in Barbados. This rate barrier of 5-10% apparently was the main reason why Montserrat intended to replace its annual value rates with a capital value tax structure, thereby permitting a lower apparent rate.

The rate structures of Barbados, Grenada, and Jamaica are graduated with the value of individual properties. Jamaica's basic rate structure starts at a flat J$5 on the first J$2000 of land value; it then increases from 1% on land values between J$2000 and J$6000 to 4.5% on values over J$50,000. (The Jamaican dollar is equivalent to about U.S.$0.56.) These rates are subject to surtaxes which, commencing in 1976/77, ranged from 10% of tax on values between J$12,000 and J$13,000 to 50% of tax on values over J$50,000. Such rates may appear to be relatively high, but in 1975 about 80% of property owners paid only the nominal charge of J$5 and only about 6% (3050) paid the top marginal rate of 4.5% on property assessed to over J$50,000.[13] Moreover, the tax is applied to unimproved land value and would be equivalent to a much lower rate on capital value (including improvements). If, for example, a house were valued at twice the value of the site, the tax rate yielding the same revenue would be one third of that on the land alone, that is, a top marginal rate of 1.5% (plus surtax), rather than 4.5% (plus surtax).

Grenada's rates range from nil on residential property valued under EC$15,000 to a maximum of 0.5% on property valued at EC$200,000 and over. (The Eastern Caribbean dollar is equal to U.S.$.37.) Commercial property is subject to a 0.8% rate, and property used primarily for agriculture, only 0.1%. These rates are surprisingly low for a tax on land and improvements, especially for a leftist government.

Barbados' land tax was introduced in 1972 at a uniform rate of 1%. In 1975 a new concept, "improved site value", was established and differential rates were introduced. Improved site value is the value of all improved properties in excess of BDS$10,000; all improved land with a value under BDS$10,000 was taxed at a site value rate of 1%, while improved land with a value over BDS$10,000 was taxed at only 0.25%. In 1978 the corresponding rates were increased by 0.25 percentage points to 1.25% and 0.5%. In 1979 a graduated rate system was introduced as follows (the BDS$10,000 exclusion for improved land still applies):

Value in BDS$	*Site Value (%)*	*Improved site value*
under 50,000	1.25	–
under 50,000	2.00	–
under 250,000	–	0.5
over 250,000	–	1.0

The lower rate for improved site value has created many anomalies as land was developed. If, for example, plantation land with a site value of BDS$250,000 were improved by a house worth BDS$50,000, property taxes would be reduced by 62% – from BDS$4625 to BDS$1750. Because of various reliefs, tax exempt prop-

11. Records of Directorate of Surveys, Bridgetown, Barbados.
12. Caribbean Community Secretariat, Report of the First Meeting on Property Tax Administration, op. cit.
13. O. St. Claire Risden, "A History of Jamaica's Experience with Land Taxation based on the Site Value System", 1976 (mimeographed), Table I.

erty, and much property with unidentified owners, the average effective rate in 1981 was only about 0.6%.[14]

b. The tax base

If current market value of property or annual rental value in its highest and best use is accepted as a standard for assessment, the tax base in all these countries falls short of yielding the potential tax revenue at the rates described above. Such deficiencies arise from a bias inherent in the assessment process to undervalue property, the lag in assesment behind changes in property values owing to the assessment cycle, especially in an inflationary period, and the provision of categorical relief for agriculture, resort facilities, certain residential properties, and hardship cases.

In the absence of empirical studies it is not possible to determine the accuracy of asessments in reflecting market value. Inferences may, however, be drawn from the frequency of appeals. While these ran rather high in Jamaica's original reassessment program, especially in the urban areas, Barbados experienced fairly low ratios both in its initial land assessment and in the later valuation of improvements. Because of Barbados' lack of an experienced valuation staff and the haste with which the exercise was completed in 1975, an undervaluation bias would be indicated by the fact that only 884 objections were raised by 13,417 property owners.[15] Barbados has since introduced an intensive training program to improve its valuation techniques.

The length of the assessment cycle is an important factor in underassessment, especially in a developing economy. (The reverse may be true in a depressed economy, such as Jamaica and other countries of the area have experienced.) Some indication of the lag of assessed values behind real values is revealed by the experience of Barbados, which is on a fairly short cycle of 3 years. The following data show the aggregate assessed values since introduction of the new site value tax in 1972:

Revaluation year	*Number of parcels*	*Assessed values (millions of BDS$)*
1972	50,160	637.5
1975	54,389	1402.8
1978	62,117	1507.2
1981	66,515	2540.6

The sharp jump in 1975 can be attributed largely to the inclusion of improvements in the base. Despite a 14% increase in the number of land parcels by 1978, indicating substantial development, the assessment roll increased by less than 7%. Between 1978 and 1981, however, a period of inflation and expansion, assessed values increased by almost 70%. This implies substantial interim undervaluation that is characteristic of property taxation generally.

All of the countries, even those with nominal annual value rates, provide for property tax relief, whether in hardship cases or for certain categories of property owners.

Serious gaps between tax assessed on market value of property and ability to pay are not uncommon. This is especially true of agricultural land located in developing suburban areas. Various techniques have been devised to alleviate this problem, the most common being so-called value in use, that is, value based on estimated yield of the crops. Barbados provides relief for owners of agricultural land if valuation takes into account its potential for subdivision or other commercial use; application is made to a Land Taxation Relief Board and if relief is granted it is valid until the next assessment. Jamaica in effect derates the value of all land that is in agricultural production by an arbitrary 75%. (Hotels are derated by 25%.)

Relief is also generally granted to residential property owners who can show hardship. This is a common situation in the Caribbean Community when land originally acquired by liberated slaves in the early 19th century and now owned by their descendants has sharply risen in value because of its favorable location in developing areas. When the owner of such land does not have an income that reflects its assessed value, he may apply for relief under special provisions of the tax law in most of these countries. In Barbados, for example, the owner of a single family dwelling need not show hardship if the assessment reflects its site value for a hotel, commercial or industrial location, residential apartment, or subdivision.

4. COST OF ADMINISTRATION

It is generally recognized that an effective system of property taxes may entail greater comparative costs of administration than other sources of revenue, especially sales and income taxes. This is due largely to the cost of maintaining a valuation department, but also to the cost of enforcing payments of tax by the great majority of property owners in developing countries with only nominal tax liabilities. Because the valuation department is also charged with other duties, and the collection department's budget sometimes covers other functions as well, it is not easy to derive a pure cost estimate. Data for Barbados in 1981/82 show a gross cost ratio of 13.5%, but arbitrary allocation of costs of both the collection and valuation departments indicate a cost ratio nearer 10-11%.[16]

It should be noted that these data relate to a property tax that includes improvements as well as land, has a modest rate structure, and provides considerable relief. A tax based on site value alone and with appreciable higher rates and yield could be administered much more efficiently. The inclusion of buildings greatly increases the

14. Following the 1981 revaluation the comparative data for site value and unimproved site value were as follows:

	Site value	Improved value (BDS$ in millions)	Total
Number of parcels	47,162	19,353	66,515
Assessed value	BDS$346.9	2193.7	2540.6
Revenue collectible	BDS$4.3	11.0	15.3

15. C.P. Thompson, "The Property Tax System of Barbados", in Conference on Property Tax Administration, St. Kitts, 10-11 November 1980 (mimeographed).

16. Based on estimated revenue of BDS$14.2 million, a budgeted figure of BDS$956,354 for collection and BDS$96,370 for valuation. The collection department also issues some 30,000 automobile licenses, dog taxes, and other licenses, while the valuation department provides other services to the government.

burden of keeping up-to-date records of improvements, based on building permits. But more important, their valuation requires on-site inspection by trained valuers and a record made of the building's dimensions, floor plan, building type, quality of construction, age, and condition. Standards must be established for unit values for different types of construction and applied to the valuation of the building. Land, in contrast, can be valued on a mass basis once the land cadastre is established.

The determination of annual value is facilitated where tenancy prevails; serious problems may arise, however, in valuing land and owner-occupied buildings, especially factory and other specialized buildings. It is usually necessary in these cases to derive an annual value based on some arbitrary ratio to the estimated capital value of the property, as was described above for Montserrat. Sometimes standard units of value per square foot or cubic foot are applied to the area or cubic space of a building in arriving at annual values. In Roseau, Dominica, for example, the annual value of owner-occupied property is assumed to range from EC$1.00 per cubic foot for property up to 5 years in age to EC$0.40 per cubic foot for property over 20 years of age, less 40%. Rental property – less than 25% of all parcels – is valued at 10 times the monthly rental. This procedure is simple to apply but of course is fairly crude in that it does not distinguish between different qualities of construction or style of building. Accordingly, a movie theatre of simple frame construction but with large space could be assessed much higher than a masonry bank building.

It is sometimes charged that the property tax in the Eastern Caribbean Community subregion (i.e. the Leeward and Windward islands) is unproductive because the cost of administering the tax on low-valued holdings exceeds the revenue. St. Lucia's experience with its rural land and house tax is cited as an example of inefficiency in this respect. It is claimed that perhaps 80% of all properties on the tax roll, with a rental value of about EC$600 and less, contribute less revenue than it costs to administer.[17] Clearly, the problem lies in the unusually low rate of tax: ½% of annual value; should this be increased to a moderate rate of, say, 5%, the problem would largely disappear. (An annual value tax of 5% is equivalent to a rate of about 0.5% of capital value, assuming a 10% gross rate of return.)

Jamaica largely avoided this problem with its land tax by the levy of a minimum tax on property with an estimated value below J$2000; for such low-valued holdings it also is unnecessary to exercise the usual care of specific valuation. Barbados, on the other hand, does not provide for any special treatment of low-valued holdings. In excluding improvements on land with a value of BDS$10,000 and less, however, the 1.25% rate rather than the 0.5% improved site value rate applies, thereby increasing the collectible tax. Also, Barbados excludes virtually all wooden houses from the tax roll, including so-called chattel houses built on leased land, and thereby reduces the valuation burden for low yield properties. It is said that low-valued parcels do not present any special enforcement problem because payment of tax strengthens the claim of ownership of the property, in which the taxpayer takes pride.

5. REFORM OF THE PROPERTY TAX

The above analysis clearly shows that CARICOM countries are not realizing the revenue potential of their property taxes. The poorest record is that of the states that have clung to the traditional British annual value mode. But the others that have reformed their system – Barbados and Jamaica — have undermined revenue by undue concessions either in rates or base. Grenada's newly adopted capital value tax appears to be following the same path with concessionary rates and exemptions. Reform of property taxes in the CARICOM would therefore appear to warrant serious consideration.

In addressing the problem of reform it might be asked what the proper role of the property tax should be in mobilizing resources by the government. Traditionally, property taxes have been a principal source of local rather than national finance.[18] In addition to CARICOM countries, important exceptions are found in Colombia, Chile and a few small countries such as Mauritius. One objective is the mobilization of resources of the agricultural sector by the state; this approach is especially important when agriculture either is exempted from income tax or an income tax on farmers is difficult to enforce and no alternative approach is introduced.[19] CARICOM countries with no or ineffective income taxes on agriculture either do not tax agricultural land or tax it at preferential rates as in Jamaica and Grenada.

A property tax at the national level presupposes a centralized form of government where cities and towns are dependent on the national government for major support of services normally performed at their level. Local property taxes, however, generally are poorly administered when the jurisdiction is too small to support the technical skills necessary for proper valuation and maintenance of the system. Centralized control or administration better assures the enforcement of objective valuation standards and avoidance of discriminatory practices and other abuses. There is no reason, however, why local governments should not share in centrally administered taxes on property located in their jurisdiction. In Chile, for example, municipalities receive one fourth of the national revenue.

The smaller states of the Eastern Caribbean common market subregion as well as Guyana and Trinidad and Tobago would appear to have most to gain by radical reform of their annual value rates; Belize, with a tax based on land area, also could greatly benefit. Montserrat's experience sets an example for reform by the Eastern Caribbean group although it is questionable whether improvements should be included in the tax base (discussed below).

Annual value, of course, reflects capital value, that is, the value of land and improvements. But an annual value

17. In 1979 the 3,000 lowest valued parcels yielded only EC$10,000, an average of EC$3.33 per parcel. British Development Division, Bridgetown, Barbados.

18. George E. Lent, "The Urban Property Tax in Developing Countries", *Finanzarchiv* 33 (1), (1974), pp. 45-72.

19. See Richard M. Bird, *Taxing Agricultural Land in Developing Countries* (Cambridge, Mass., 1974), passim; George E. Lent, "Taxation of Agricultural Income in Developing Countries", 27 *Bulletin for International Fiscal Documentation* (1973), pp. 324-42.

tax is bound to be a hybrid because of the necessity of estimating the rental value of owner-occupied property to arrive at uniform assessment with respect to rental properties. This is especially difficult in the case of owner-occupied land. Because most farm land and residential property in these countries is owned by the occupier, the annual value concept is basically incompatible.[20]

One important factor inhibiting revenue is the high level of annual value rates that would be necessary to equate tax with a rate based on capital value or site value. The traditionally low level of annual value rates in the CARICOM – ½ to 1% – yields only a fraction of the revenue that a comparable rate based on improved or site value yields. Moreover, as was noted above, such low rates are unproductive because the cost of administration may exceed the tax collected on a large proportion of the parcels, as in St. Lucia. The effectiveness of overcoming this "rate illusion" is attested by Montserrat's intended strategy of converting annual value rates to rates based on capital value.

If the validity of these objections to annual value rates is accepted, what system offers the best alternative – site value or improved land value (i.e. capital value)? The initial decision of both Barbados and Jamaica was in favor of site value, although only Jamaica has stuck with this decision. Trinidad and Tobago initially declared for a modified site value tax but new conditions militated against a change.

Either site value or capital value is more consistent with land tenure in these countries, where the preponderance of property is owned by the occupier. Assessment of property could be achieved on a more equitable basis by avoiding the intermediate step in annual value assessment of converting capital value of owner-occupied property to annual value by an assumed arbitrary rate of return or other formula. Perhaps a more important factor favoring site value was the administrative convenience of mass assessment of land, which greatly facilitated the transition. Valuation of improvements would have compounded the burden on a limited and virtually untrained staff, greatly delayed implementation of the new tax, and built in greater problems of maintaining future assessment rolls. Barbados' later experience with its modified site value system confirms the difficulties of coping with the additional task of valuing improvements.

Finally, a tax limited to site value is most consistent with economic development objectives in that improvements to land are not deterred by an additional tax on their value. Indeed, a high enough rate would spur more intensive use of idle land.[21] It is true, of course, that the tax rate on land plus improvements would be lower than the rate on site value alone to yield equivalent revenue. The greater investment that might be attributable to a site value tax, however, would induce a greater increase in land values – the "unearned increment" – that could be recaptured by the higher site value tax rate.

The above view assumes that the rate on the value of land and improvements would be the same, unlike Barbados' curious rate structure that reduces the rate applicable to improved site value. The anomaly of this schedule is evidenced by an average rate in 1981 of 0.5% on improved land as against an average rate of 1.25% on site value alone. This rate structure has the effect of placing a premium on low-valued improvements in relationship to the value of land, and thereby militating against optimum allocation of resources. For example, only if the value of the improvement on land worth BDS$500,000 were greater than the value of the land would the property tax be increased. The incremental tax on improvements of much greater value, at a 1% rate, would be much less than the tax increment of a uniform rate on land and improvements. In this respect, Barbados' rate structure places less tax penalty on new investment than an orthodox tax on improved value but more than a site value tax.[22]

It is concluded from the above analysis that reform of annual value rates by CARICOM countries could best take the form of a tax on unimproved site values. A modest rate of, say, 1% would greatly enhance revenue, improve administrative efficiency, improve equity, and provide incentives for new investment. Many of these countries already have in place a legal cadastre that would facilitate the transition; others would require the installation of a property cadastre for fiscal administration. All would require a program for valuation of land under the direction of experienced valuers. Such a program would take time for planning, organizing and training technicians, and installing proper records, preferably computerized.

Countries that have replaced the annual value and other forms of property tax also could improve revenue by reducing or eliminating undue relief provisions for agriculture and hotels and rationalizing their rate structure. Barbados, in particular, should revise its rate structure so as to avoid the anomalous effect of a lower tax on improved land than on land alone. Rather than reverting to a site value tax, one possibility is a two-level tax consisting of a (graduated) rate on site value and a somewhat lower rate on improvements. Another possibility is a modified site value tax patterned on that of Montserrat.

20. It is estimated, for example, that 93% of Dominica's rural land parcels and more than 75% of its urban land is owner-occupied.

21. In Montserrat it is claimed that the land tax has forced more productive use of land either in agriculture or in subdivision and development. Caribbean Community Secretariat, "Taxation of Land and Buildings in Montserrat", op. cit., p. 8.

22. The reasons for the change to modified site value are stated to be as follows: A site value tax can have little effect on development unless capital is available; improvements that have been made are evidence of access to limited financial resources and should be able to bear tax; and, a larger base would permit a lower tax rate and reduced taxes on vacant land and agricultural land. C.P. Thompson, "The Property Tax System of Barbados", op. cit.

CUBA

Taxation of Joint Ventures

By M.A. Gª Caballero

I. INTRODUCTION

In order to attract foreign investment to team up with Cuban concerns in selected projects required to fulfill economic development goals, Decree-Law 50/82 of February 15 provides the legal framework within which business collaborations are to be organized in order to be eligible for privileged or special tax treatment.

Decree-Law 50/82 provides the rules applicable to business collaborations between Cuba and foreign enterprises, distinguishing between joint ventures (empresas mixtas) which constitute separate legal entities, and other types of business collaboration (for instance temporary associations) which do not. Either type, however, may receive privileged or special tax treatment: in the case of a joint venture, it is the separate legal entity and its foreign shareholders, directors and employees who benefit; in other types of business association, it is its foreign members, directors and employees.

The discussion below describes the most important foreign investment and tax measures relating to joint ventures.

II. FORMING A JOINT VENTURE

1. Concept

A Cuban joint venture consists of a collaboration agreement between Cuban public or private enterprises and foreign individuals and/or corporate enterprises which contributes to the economic development of the country, especially in the export and touristic sectors.[1] A joint venture is created by a notarial deed and is a seperate legal entity.

2. Requirements

The requirements relate mainly to the capital investment and to labour.

1) Investment requirements

a. the investment project and the by-laws of the joint ventures must be apporved by an "ad hoc Commission" appointed by the cabinet;
b. the joint ventures must be organized as a corporation (sociedad anónima) and domiciled in the Cuban Republic.[2] However, the Cuban joint venture may have permanent establishments and subsidiaries abroad, and may also praticipate in the capital of foreign companies;
c. a majority of locally owned equity is required; foreign shareholding is limited to 49%, unless the cabinet allows greater participation (in exceptional cases). Foreign contributions may be paid in foreign currency or in kind;
d. a legal reserve account must be established out of the annual profits to cover eventual liabilities in the manner established by the State Finance Committee[3];
e. the joint venture must open its business account in a convertible currency with a local bank through which all transactions are to be channelled. The official exchange rate of Banco Nacional de Cuba (the central bank) applies.[4] The joint venture is entitled to borrow in foreign currency from local banks and from foreign sources[5];
f. the notarial deed of incorporation must be registered with the State Chamber of Commerce.[6]

2) Labour requirements

a. The workforce of the joint venture must be hired and paid by hired and paid by the Cuban partner enterprise or by an independent Cuban entity; the workforce must be composed of Cuban nationals. Some of the directors and some highly specialized technical personnel may, however, be foreigners. Subject to the immigration rules, the joint venture may hire the required technical and administrative personnel. The Cuban partner or the independent entity then hires the Cuban workforce to the joint venture for a monthly sum, calculated according to official Cuban wages. Cuban directors and managers, however, earn the remuneration agreed upon by the partners concerned, provided that such remuneration is similar to that earned by the foreign directors and managers.
b. It is compulsory for the joint venture to create an economic incentive fund for its Cuban employees, out of which each Cuban employee receives fringe benefits. The amount which the joint venture is obliged to allocate to such a fund and the manner in which fringe benefits are paid is established by the "ad hoc Commission" when the authorization to create the joint venture is granted.

1. The same definition applies to other types of business associations, except that no separate legal entity is formed.
2. The Republic of Cuba constitutes an archipelago made up of two main islands (i.e. Cuba and Isla de Pinos) and around 1,600 islets, whose total area is 110,922 km2 (42,823 sq. miles) and whose total population (census of September 11, 1981) is 9,706,369.
3. The address of the Comité Estatal de Finanzas is: Obispo y Cuba, Ciudad de la Habana.
4. The official average rate of the Cuban peso against dollar is P80.1 cents per 1US$. The address of the Banco Nacional de Cuba is: Cuba, 402, Ciudad de la Habana.
5. The members of other types of business associations may also do so.
6. The collaboration agreements of other types of business associations only enter into force after having been registered in such a Registry.

III. TAXATION OF A JOINT VENTURE

1. Privileged tax treatment for qualified investments

Where a joint venture is engaged in the development of areas which have been declared zones of great interest for touristic purposes by law 33/81 of January 10, the joint venture may benefit from a total or partial exemption from taxes and from customs tariffs and duties. Provided that the investment project in considered to be highly beneficial for the national economy, the State Finance Committee may grant joint ventures[7] a total or partial exemption during a given period from tax on net profits (see taxation of a corporate joint venture below) and from customs tariffs and duties.

In any case, the corporate joint venture and its foreign shareholders, directors and employees[8] are granted special tax treatment. This treatment includes:

(i) an exemption from income tax levied on the gross income of private enterprises, individual shareholders, partners, directors and employees[9];

(ii) an exemption from transfer tax, levied at the rate of 3.6% on the value of alienated real estate, business establishments, and equity capital.[10]

2. Taxation of a corporate joint venture

Where no exemption is applicable, a corporate joint venture[11] is subject exclusively to customs tariffs and duties, to an annual tax on motor vehicles for land transport, to a stamp duty on the application for, obtaining and renewal of certain documents, and to two direct taxes: (i) the net profit tax and (ii) the payroll tax.

The net profit tax (impuesto sobre utilidades)[12]

The net taxable base is calculated by deducting from the annual net profits (i) the portion of profits reinvested in increasing the equity capital of the joint venture or contributed to other types of business associations, (ii) that portion of profits which is allocated to the legal reserve account, as established by the State Finance Committee, and the portion allocated to a voluntary reserve account as agreed by the parties concerned, and (iii) that portion of profits allocated to the economic incentive fund for the Cuban employees, as established by the "ad hoc Commission".

The net taxable base is then subject to tax at the rate of 30%. The tax liability so assessed must be paid before March 1 of the following year. No tax credits are available.

The payroll tax (impuesto sobre nóminas)

This tax was introduced by Law 1213/67 of June 27 and is generally levied on the total amount of salaries, wages and any other type of compulsory remuneration paid by private enterprises to their employees.

As an exception, the payroll taxable base for joint ventures[13] is the total amount of salaries, wages and any other type of compulsory remuneration paid to the Cuban workforce, except the fringe benefits paid out of the economic incentive fund.

The taxable base is subject to payroll tax at the rate of 25% which includes the compulsory social security charges.[14]

The tax liability so assessed must be paid each month, at the same time as the salaries paid to the Cuban workforce.

IV. REMITTANCE ABROAD OF INCOME AND REPATRIATION OF CAPITAL

Foreign employees may freely remit abroad the portion of earned income stipulated by the central bank.

Foreign shareholders in the joint venture[15] are guaranteed by the Cuban State the free remittance in foreign currency of gross dividends, interest and royalties, as well as the portion of the sale or liquidation proceeds corresponding to their participation in the Cuban joint venture, provided that such remittance and repatriation is effected through the central bank.

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7. The members of other types of business associations may also benefit from these exemptions.
8. Also applicable to foreign members, directors and employess of other types of business associations.
9. The Cuban income tax (impuesto sobre los ingresos) was introduced by Law 998/62 of January 5, as amended by Law 1213/67 of January 10. Private enterprises are subject to this tax at the rates resulting from coefficients established by the State Finance Committee for the different types of business activities; the taxable income is the annual gross income without any deduction. Individual taxpayers are subject to this tax on the monthly income from labour and from capital at progressive rates. These rates are as follows:

Monthly income between Pesos$	Pesos$	Rate % to be applied on monthly income (per bracket)
0	250.	11.9
251	300.	14
301	400.	16
401	500.	18
501	600.	20
601	700.	22
701	800.	25
801	1,000.	30
1,001	1,250	35
1,251	1,500	50
1,501	1,750	55
1,751	2,000	60
2,000	2,500	65
2501	. . .	70

10. The transfer tax (impuesto sobre transmisión de bienes inmuebles, establecimientos mercantiles y herencias) was introduced by Law 998/62 of January 5.
11. Also applicable to the members of other types of business associations.
12. The tax is assessed by calendar years, thus the financial and fiscal year coincide with the calendar year.
13. Also applicable to the members of other types of business associations.
14. Employess receive benefits from the state social security fund for sickness, accident, maternity, disability, unemployment and retirement. Public enterprises must pay to the Social Security Fund 10% of the payroll expenses according the Decree-Law 44/81 of July 6.
15. Also applicable to the members of other types of business associations.

The Tax System of the People's Republic of China – A Short Survey

by Eugen Jehle *

I. INTRODUCTION – SCOPE OF ARTICLE

For about three years now, the People's Republic of China has aroused the interest of the international business community, which, of course, includes the interest of all those who are involved in taxation.

The tax laws that were introduced by the Chinese Government in the early 1950s and later amended in 1958 are now supplemented by new tax laws (and the pertinent regulations) which include the Individual Income Tax Law of 10 September 1980, the Joint Venture Income Tax Law of 10 September 1980, and the Foreign Enterprise Income Tax Law of 18 December 1981.

This article discusses the current tax system of China, and for that purpose, the taxes have been divided into three major categories: direct taxes; indirect taxes; and registration taxes and license duties.

It should be noted, however, that this discussion does not consider the taxation of state-owned enterprises which, until fairly recently, were fully integrated into the State's economic planning. This meant that all profits had to be transferred to the State and that the State had to bear the losses when they occurred. Since 1979, many experiments have been going on to change this situation, and eventually, state-owned enterprises will become subject to tax on profits, fixed assets and other items.

At this stage, however, it is too early to talk about *the* tax system for state-owned enterprises. There will always be differences in the various provinces and municipalities and with respect to different types of activities. In a recent article on this subject,[1] the author concluded that tax experiments in China are so numerous that attempting to obtain a complete understanding of the prospective tax changes is not yet possible.

Contents

II. CLASSIFICATION OF TAXES LEVIED IN THE PEOPLE'S REPUBLIC OF CHINA

A. Direct taxes

1. The foreign enterprise income tax[2]

This tax is part of the most recent tax legislation and may well turn out to be one of the most important taxes, certainly as far as concerns the raising of revenue for the treasury. The purpose of this tax is to tax all Chinese-source income which is not otherwise taxed under other laws such as the Individual Income Tax Law or the Joint Venture Income Tax Law. As the name indicates, the tax concerns exclusively foreign enterprises, and with regard to such enterprises, the tax "takes over" the task previously carried out by the industrial and commercial income tax.

In identifying "taxable persons", a distinction is made between foreign enterprises that are actively engaged in business in China (i.e. enterprises that are present in China) and those that receive "passive income" from China (i.e. enterprises that are not present in China). This distinction is important with respect to the rate of tax that applies (see discussion below).

* Senior Research Associate, International Bureau of Fiscal Documentation. This article is based on a talk which the author delivered on 11 June 1982 at the *Workshop on Chinese Law* organized by the Europe China Association (Square de la Quiétude 7, B-1150 Brussels, Belgium) at the Institut de Recherches Juridiques Comparatives, Section Chine, Centre National de la Recherche Scientifique, Ivry, France.

1. Jap Kim Siong, "China's recent tax experiments to revive the industrial and commercial tax system of state enterprise", 36 *Bulletin for International Fiscal Documentation* 2 (1982) at 66.

2. The Foreign Enterprise Income Tax Law of 18 December 1981; Detailed Rules and Regulations for the Implementation of the Income Tax Law of the People's Republic of China concerning Foreign Enterprises of 17 February 1982.

The underlying legislation wisely uses the general term "foreign companies, enterprises and other economic organizations" and does not restrict itself to "corporations". Thus, it protects its tax jurisdiction over any entrepreneurial operations that are defined as taxable in this law.

Income of foreign enterprises from the active conduct of business in China includes profits from cooperative production, processing activities and other business operations, such as exploration and other projects performed under a contract. Such income also includes income from independent business operations undertaken through an establishment in China. At this time, however, it is not entirely clear which types of activities of an establishment in China trigger liability to this tax.

"Passive income" is defined as dividends, interest, income from the rental or transfer of property and other income which is not from the active conduct of business.

The following rules are important in determining the taxable income of enterprises that actively engage in business in China:

(i) the relevant accounting method is the so-called "accrual method", i.e. the value of the property of the enterprise at the end of the year is compared to the value at the beginning of the year and the difference is the profit or loss;

(ii) income must be calculated on an annual basis, and as a general rule, the tax year is the Gregorian calendar year; however, other taxable periods may be applied for;

(iii) the procedure for calculating taxable income is precisely set forth in the underlying rules and regulations which distinguish among industry, commerce, service trades and other trades.

The Foreign Enterprise Income Tax Law identifies certain expenses that are either not deductible at all or deductible only to a limited extent. Non-deductible expenses include payment of the national or local income tax, penalties for illegal operations, overdue payments and tax penalties, certain losses covered by insurance, royalties paid to the head office, and other expenses that are not relevant to production or to the business operation.

Expenses which are deductible to a limited extent basically include three types of expenses: administrative, interest, and entertainment expenses. Administrative expenses (also known as overhead expenses) are deductible only if certain requirements are satisfied. For example, any such payment must be for a service rendered directly to the undertaking in China. Interest payments are deductible only if the interest rate passes the test of "reasonableness". Entertainment expenses are deductible only if they do not exceed certain percentages, i.e. a certain percentage of either net volume of sale or the total annual business income. These provisions are clearly designed to combat tax evasion in its various disguises.

The provisions concerning depreciation, treatment of losses, valuation of stock, etc. are precisely set forth in the underlying legislation and they basically follow the schemes commonly employed in other countries.

The Foreign Enterprise Income Tax Law identifies several items of income that are exempt from the tax. Exempt income includes interest payments on loans given by international financial institutions to official Chinese bodies or on loans given by foreign financial institutions to Chinese State Banks which were given at a "preferential" rate. Whether or not the rate is "preferential" is usually specified in the underlying loan agreement.

The rate of tax depends on whether the income is from the active conduct of business in China or is passive income. The former is taxed at progressive rates that vary from 20% (for an annual income of less than 250,000 yuan) to 40% (for that part of the annual income that exceeds 1,000,000 yuan). In addition to this tax, which is in fact a national tax, a local income tax at the flat rate of 10% is levied on the same taxable income. Thus, if taxable income is 250,000 yuan, the actual tax burden is 75,000 yuan, i.e. 30%. If the annual income is 10,000,000 yuan, the total tax burden is 48.75%.

This tax burden may, however, be reduced by claiming the various tax incentives that are provided for particular types of activities. For example, long-term undertakings (i.e. which have been in operation for at least 10 years) in specific fields may apply for a tax holiday for the first year in which they made a profit and for a tax reduction of 50% for the subsequent two years. In addition, depending on various factors, they may apply for a reduction of 15% or 30% for the following ten years. Finally, an exemption from, or a reduction in, the local income tax may be applied for in specific circumstances.

Passive income received by a foreign enterprise is subject to income tax at the flat rate of 20%.

2. The industrial and commercial income tax[3]

The industrial and commercial income tax is levied on the profits of domestic (Chinese) "industrial and commercial enterprises", and until the promulgation of the Foreign Enterprise Income Tax Law, of business activities (in China) of foreign enterprises. With regard to the latter, it was, however, common practice to arrange, in the underlying contracts for a tax holiday, at least a temporary one.

This tax is not levied in a uniform manner all over China, and there are areas where industrial and commercial enterprises are temporarily exempt from this tax. The latest report on this subject indicates that such enterprises in Tibet have been exempt from the industrial and commercial income tax for several years.

Subject to this tax are "industrial and commercial enterprises" such as cooperative societies, industrial and commercial activities of people's communes, mixed enterprises (partially private and partially state-owned; the most prominent example is the Bank of China), and private enterprises. State-owned enterprises and agricultural activities carried on by people's communes are not subject to this tax.

Taxable income is net revenue calculated according to the accrual method. No distinction is made among vari-

3. Provisional Regulations for the Industrial and Commercial Income Tax of 10 December 1950, as amended.

ous items of income. For example, capital gains, i.e. extraordinary profits from the disposal of fixed assets, are automatically included in the profits.

The following items are deductible in calculating taxable income: production costs, administrative expenses, and other expenses; depreciation using the straight-line method; and the industrial and commercial consolidated tax that was paid (see discussion under "Indirect taxes").

Many exemptions are provided, but it appears that the situation varies from province to province. An exemption may be for an area or for specific branches of industry and commerce, or the exemption may be granted for retained profits and for new industrial enterprises having financial problems.

The industrial and commercial income tax is levied, at the national level, at progressive rates ranging from 5.75% for incomes up to 300 yuan to 34.5% for incomes of 10,000 yuan or more. In addition, a local surcharge may be levied which ranges from 10% to 100% of the national tax.

3. The joint venture income tax[4]

The joint venture income tax is levied exclusively on enterprises that are established under the "Law on Joint Ventures Using Chinese and Foreign Investment" of 1 July 1979. This law states that a joint venture has to be established as a "limited liability company" which is the taxable person. The law also makes it possible for a joint venture to have branches abroad, and if it does, the head office in China will always be the taxable person for tax purposes and will therefore be liable for payment of the Chinese taxes.

Taxable income is the joint venture's world-wide income that represents (i) income from production and business (which covers virtually every activity) and (ii) income from other sources such as dividends, bonuses, interest, royalties, and other sources. Taxable income, determined according to the accrual method, is gross income less costs, expenses and losses. In addition, the following rules apply:

(i) the procedure for calculating taxable income follows closely the procedure in the foreign enterprise income tax, i.e. distinctions are made among industry, commerce, service trade and other kinds of operations;
(ii) the taxable period is the Gregorian calendar year;
(iii) the provisions regarding non-deductible expenses and entertainment expenses also closely follow the provisions in the foreign enterprise income tax;
(iv) losses may be carried forward and set against the profits of the next year; the maximum period for carrying forward losses is five years; and
(v) fixed assets will normally be depreciated using the straight-line method.

The Joint Venture Income Tax Law does not contain any exemptions. However, some tax incentives are available (see discussion below).

The joint venture income tax is levied at a flat rate of 30% which is the national tax. In addition, a local surcharge of 10% of the national tax is levied, and the total tax burden is thus 33%. However, the People's Government of the Province, Municipality or Autonomous Region in which the joint venture is seated may decide to grant a reduction of, or exemption from, the local surcharge on account of special circumstances.

If a foreign participant's share in the profits of the joint venture is remitted to a place outside China, an additional income tax of 10% is levied on the amount remitted.

Tax incentives are available which are very similar to those available under the Foreign Enterprise Income Tax Law, namely, a tax holiday in the first profit-making year and a tax reduction of 50% in the two subsequent years. In addition, a reduction of 15% to 30% may be applied for up to ten more years. Certain conditions must be satisfied in order to qualify for these incentives. For example, the joint venture must be long-term, i.e. have been in operation for at least ten years.

A foreign participant of a joint venture is entitled to a tax refund of 40% of the income tax paid on his share of the income that is reinvested in China for a period of at least five years.

Where a joint venture or its branch derives income from abroad and has paid foreign income taxes thereon, the foreign taxes may be credited against the income tax liability in China. In this regard, it may be noted that, to date, China has not concluded any comprehensive treaties for the avoidance of double taxation, but, reportedly, negotiations are going on with several countries.

4. The individual income tax[5]

On 10 September 1980, the Individual Income Tax Law entered into force. It is a kind of schedular tax (the method of taxation varies with the kind of income) which is in contrast to a global income tax pursuant to which all items of income are added together and taxed at a uniform rate. Before it entered into force, there was no individual income tax in modern China. The only exception referred to those cases where activities were undertaken by an individual (private enterprise) that qualified as an industrial and commercial enterprise and was thus subject to the industrial and commercial income tax.

Taxable persons are individuals who either live in China or who receive income from China, and the law distinguishes between residents and non-residents.

With regard to residents, further distinctions are made depending on how long the person has resided in China. Individuals who have resided in China for more than five years are, from the sixth year of residence, subject to Chinese income tax on their world-wide income. Individuals who have resided in China for one or more years but less than five years are subject to tax with regard to their Chinese-source income and that part of their foreign-source income that is remitted to China. Individuals who have resided in China for less than one year

4. The Income Tax Law of the People's Republic of China concerning Joint Ventures with Chinese and Foreign Investment of 10 September 1980; Detailed Rules for the Implementation of the Income Tax Law concerning Joint Ventures of 14 December 1980.
5. Individual Income Tax Law of the People's Republic of China of 10 September 1980; Regulations for the Implementation of the Individual Income Tax Law of 14 December 1980.

are subject to Chinese income tax only on their Chinese-source income.

The individual income tax identifies six types of income that can be classified in three categories:

(i) employment income;
(ii) compensation for personal services; royalties; rental income;
(iii) taxable interest, dividends and bonuses; other kinds of income which the Minister of Finance has identified as taxable.

Employment income consists of wages, salaries, certain bonuses and year-end extras that are paid in the course of an existing employment relationship. However, the following types of income do not constitute taxable employment income: certain retirement and welfare payments; salaries of foreign diplomatic personnel; and remuneration paid by employers outside China to individuals whose period of residence in China does not exceed 90 days.

Employment income is subject to progressive marginal tax rates. The law provides for a basic exemption of 800 yuan per month. Amounts in excess of the exemption are taxed at rates that range from 5% to 45%, and the maximum rate applies to that part of the monthly income that exceeds 12,000 yuan. Thus, the actual tax burden on a monthly net income of 5,000 yuan is 11.70%, and a monthly income of 10,000 yuan is taxed at 20.85%.

Items of income that belong to the second category are, in principle, taxed at a flat rate of 20%. Residents are entitled to a lump sum deduction for expenses of 800 yuan per payment if the payment is less than 4,000 yuan or of 20% of the payment if it exceeds 4,000 yuan. Thus, if the single payment is 2,000 yuan, the effective tax burden is 12%. For payments in excess of 4,000 yuan, the effective tax burden is 16%. Non-residents are not entitled to this deduction, and the 20% rate applies to their income which falls in this category.

Items of income within the third category are, in principle, taxed at a flat rate of 20% and no deductions are allowed. However, some exemptions are available. For example, interest that is defined as interest from a savings deposits in a State or cooperative bank in China or any other bank authorized by the State bank is exempt from the individual income tax. Dividends derived from a joint venture or an urban or rural cooperative organization are also exempt for residents.

5. The agricultural tax[6]

The agricultural tax is levied on agricultural activities undertaken by people's communes, and the taxable person is the production team of the commune. The tax is levied on the "yield of the average harvest" which is a projected amount that is usually fixed for a certain number of years (normally 3-5 years) on the basis of the harvests of previous years. Any yield in excess of the "yield of the average harvest" is exempt from taxable income.

A basic exemption is allowed. In addition, exemptions from, and reductions of, the agricultural tax may be granted when a natural disaster occurs, when new cultivations are being started, or when the agricultural activities take place in so-called "handicapped" areas.

The agricultural tax is levied at a proportional rate, but the actual rate depends on the region and usually varies from 13% to 19%. In addition, a local surcharge of up to 22% of the tax may be levied. Usually this tax is paid-in-kind.

It should be noted that this method of taxation contains a built-in incentive to increase production, and this can be done without creating any additional administrative work. Thus, it might be worthwile for other countries seeking to increase agricultural production to study this method.

6. The urban real property tax[7]

The urban real property tax is a local (i.e. municipal) tax that is generally levied on the value of real property, and the taxable person is the owner, renter or user of real property located in urban areas. Various factors, such as location, condition, etc., must be considered in determining the value of the property. Some property, such as real property used for governmental purposes is exempt from this tax.

The tax rate varies from municipality to municipality. For land, the annual rate is usually about 1.5% and for buildings, it is usually about 1%. Under certain circumstances, this tax may instead be levied on the rental value.

B. Indirect taxes

1. The industrial and commercial consolidated tax[8]

This tax is currently the most important one in China and applies to all kinds of enterprises in China, including state-owned ones. The tax may be classified as a turnover tax that has some of the features of an excise duty.

A taxable transaction arises whenever a taxable item is transferred from one enterprise or person to another enterprise or person or when an item is imported or exported. With respect to imports and exports, the tax question is usually clarified in the underlying contract, i.e. it is common practice for the Chinese enterprise or person to satisfy the tax liability.

For enterprises or persons engaged in industrial or agricultural production or in retail trade, the taxable base consists of the gross receipts. For those engaged in transportation, postal and communication services, the taxable base is gross income, and for those engaged in the service industries, the taxable base consists of the commission earnings.

There are several exemptions from the industrial and commercial consolidated tax. For example, transfers within an enterprise are usually exempt. In addition, certain import items may be exempt, the most recent example being an exemption for items to be used in the exploration and exploitation of offshore petroleum. With re-

6. Regulations governing the Agricultural Tax of 3 June 1958, as amended.
7. Provisional Regulation for the Real Property Tax on Urban Buildings of 8 August 1951, as amended.
8. Regulations and Detailed Rules for the Industrial and Commercial Consolidated Tax of 13 September 1958, as amended.

gard to transactions that occur in the context of compensation trade, processing trade and cooperative production, it seems to be common practice for the parties to arrange for an exemption in the underlying contracts.

As a general rule, the tax rates reflect the extent to which a particular commodity is necessary to the average consumer. The rate is low for items that constitute basic needs, but it is as high as 69% for luxury items. Industrial and agricultural commodities are taxed at rates that range from 1.5% to 69%. Retail sales are taxed at a uniform rate of 3%, and transportation services at 2.5%. A rate ranging from 3% to 7% applies to commissions earned by those engaged in the service industries. In addition, a surcharge of 1% of the tax due may be levied.

2. The salt tax

The salt tax is reportedly the oldest tax that is levied in China and is administered by the Salt Control Bureau. It is a tax on the production of salt and its rate varies. Certain exemptions are provided for, such as for salt used in agriculture or industry or salt that is to be exported.

3. Customs duties[9]

Although customs duties are usually not classified as taxes, they are briefly mentioned here because they are of great significance to China.

Certain exemptions are provided with respect to customs duties. For example, an exemption applies to the importation and subsequent exportation of equipment used in the exploitation of offshore oil. In addition, an exemption may apply to equipment imported for use in joint ventures and in compensation trade, processing trade and cooperative production.

a. *Import duties*

The tariff on imports is classified into 17 categories which are subdivided into 939 tariff numbers, and a distinction is made between the "minimum tariff rate" and the "general tariff rate". The former is the rate that is generally applied to imports from countries with which China has concluded a trade agreement, and the general tariff rate applies to imports from all other countries. The applicable rates may be as high as 400% for luxury items.

b. *Export duties*

Until very recently, no export duties were levied by China. However, as of 1 June 1982, an export duty is levied on 34 kinds of commodities. The export duty is usually levied on the export value and the rates vary from 10% to 60%. An exception exists with respect to coal which is taxed on a quantitative basis, i.e. 40 yuan per ton. No further details regarding export duties are available at this time.

C. Registration taxes and license duties

Taxes which, in fact, are in the nature of license duties include the slaughtering tax, the cultural and entertainment tax, and the transport means tax. These are all local taxes and the tax amount appears to vary significantly. In terms of revenue, they are of minor importance and are mentioned here only for the sake of completeness.

III. TAX TREATMENT OF SPECIFIC UNDERTAKINGS

A special tax treatment is provided for some types of undertakings and for activities in specific areas. For instance, a specific tax treatment applies to undertakings of any kind that are carried on in so-called Special Economic Zones.

To date, three Special Economic Zones have been established in Guangdong Province, namely Shenzhen, Zhuhai and Shantau. In Fujian Province, there is so far only one such zone, namely Xiamen. For the zones in Guangdong Province, detailed regulations have been released[10] that answer all kinds of questions. As far as taxation is concerned, the income tax rate has been fixed at 15%. There is, however, much room for negotiation for projects that are of specific interest to China.

The regulations for the zone in Fujian Province have reportedly been passed by the legislative bodies, and although no copy has yet been obtained, the regulations are not expected to differ widely from those in Guangdong Province.

Foreign shipping transport enterprises also enjoy a special tax treatment.[11] For them, taxable income is defined as 5% of the gross income from transport services for passengers and cargo within Chinese territory. This amount is then taxed at the rate of 4.025% which consists of 1% foreign enterprise income tax, 0.5% local surcharge thereon, 2.5% industrial and commercial consolidated tax, and 1% surcharge thereon, namely .025%.

There are other undertakings that enjoy a special tax treatment, but those mentioned above are the most important ones.

IV. CONCLUSION

The tax system of the People's Republic of China is, at this time, a mixture of well-established taxes and of newly-introduced tax laws. With regard to the latter, it will naturally take some time before all the details have been worked out.

At any rate, the Chinese authorities must be congratulated for having released, in the course of implementing the four modernizations, tax laws the brevity of which has caused much envy and admiration in the international tax community. Anyone who has to deal with the tax laws of other countries will no doubt agree with this statement.

9. Provisional Regulations governing the Customs Import and Export Tariffs of 16 May 1951, as amended.
10. Regulations of the People's Republic of China on Special Economic Zones of Guangdong Province of 17 November 1981.
11. See the law and regulations cited in note 2, above, in connection with an announcement of the Ministry of Finance of 26 February 1982.

The Welfare Cost of Taxation: Its Meaning and Measurement

by Nizar Jetha *

I. INTRODUCTION

Statements such as "the welfare cost of tax X equals a% of its revenue yield" or that "the welfare gain from substituting tax Y for tax Z would equal b% of GNP" are to be found in a growing number of papers on tax reform. They refer to the cost of distortions caused by taxes through their effects on relative prices. All taxes, except the poll tax, distort the allocation of resources in the sense that the allocation of resources would change if the taxes were removed. The concept of the welfare cost of taxation attempts to translate the cost of tax-induced distortions in money terms. The concept is based on the notion of consumer's surplus.

This paper provides an introduction to the concept of the welfare cost of taxation and its measurement. In addition, it derives the basic conclusion of the theory of optimal indirect taxation by taking advantage of the close relationship between the concept of welfare loss and the theory of optimal taxation.

II. CONSUMER'S SURPLUS

The consumer's surplus is simply the difference between the amount a consumer is willing to pay for a quantity of a good and the amount he actually pays for it. Thus, if one is prepared to pay $1 for a can of beer but its price is 40 cents, the consumer's surplus is 60 cents. Every point on the ordinary demand curve represents the sum a consumer is willing to pay for various quantities. When the price of a good X is P_0 and the quantity X_0 is purchased, the amount the consumer is willing to pay for the X_0th unit and the price are equal, but the amounts the consumer is willing to pay for the other units purchased exceeds the (fixed) price of the commodity (see Figure 1). At price P_0, the total sum a consumer is willing to pay for the quantity X_0 is given by $OScX_0$, but the amount he actually pays is given by OP_0cX_0. The area of the triangle P_0Sc, therefore, represents the consumer's surplus.

Now suppose that a tax of Tx per unit of X is imposed. The price rises to P_1 and demand falls to X_1. The willingness to pay for X_1 is represented by $OSaX_1$ but the outlay made is OP_1aX_1. The consumer surplus is now P_1Sa. The reduction in the consumer surplus due to the increase in price is, therefore, P_0P_1ac.

The decrease in consumer surplus due to an increase in price gives the total welfare loss. However, when the price increase is caused by a tax, the additional tax revenues should be subtracted from the total welfare loss because the revenues, when spent, would bring benefits. The tax of Tx per unit of X would bring tax revenues of TxX_1, denoted by the area P_0P_1ab. Hence, we are finally left with the triangle abc as the measure of the welfare cost of taxation. The loss of welfare due to taxation is variously referred to as the "excess burden", "deadweight loss" and "efficiency cost".

III. CONSUMER'S SURPLUS AND COMPENSATING VARIATION

It has been suggested that a price-induced change in consumer's surplus is given by the area to the left of the demand curve between the two prices. Strictly, the change in the consumer's surplus is not given by the area to the left of the ordinary demand curve, but by the area to the left of a compensated demand curve. The present section explains the reason for this as well as the meaning of the compensated demand curve. In the process, further light will be shed on the concept of consumer's surplus.

The upper part of Figure 2 shows income on the vertical axis and purchases of a good X on the horizontal axis. U_1 and U_2 are indifference curves, and $\overline{YZ}$ is the initial budget line corresponding to price P_1 for X. At the price P_1, the consumer spends $\overline{YR}$ of his income on X, purchasing the quantity X_1. This gives us one point on the ordinary and compensated demand curves, denoted by a in the lower part of the diagram. When the price rises to P_2, the budget line changes to $\overline{YW}$, giving a new equilibrium on the lower indifference curve U_2. The purchases of X fall to X_2 and a second point on the ordinary demand curve (b) is obtained. To obtain the corresponding point on the compensated demand curve, we need to ask what quantity of X the consumer would purchase at the higher price P_2 if his income were increased so that he could remain on the original indifference curve U_1. The answer can be found by "moving" the budget line $\overline{YW}$ to the right, keeping its slope constant, until it touches U_1. As the diagram shows, the answer is that the quantity X_3 would be purchased, and this gives us the second point on the compensated demand curve (c). Other points can be derived by considering different prices. It should be clear that the compensated demand curve is a relationship between prices and quantities when a consumer remains on a given indifference curve (that is, when his utility is held constant).[1]

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1. A simple mathematical derivation of a compensated demand curve may help. Let the utility function be of the form $U = Q_1Q_2$, where Q_1 and Q_2 are the quantities of goods 1 and 2 consumed, respectively. Let P_1 and P_2 be the prices of goods 1 and 2, respectively. Minimizing the expenditure on the two goods $(P_1Q_1 + P_2Q_2)$ subject to the initial level of utility (say U^o) being maintained will give the compensated demand curves. Minimizing the Lagrangean:

$$L = P_1Q_1 + P_2Q_2 + g(U^o - Q_1Q_2)$$

we get

$$\frac{\partial L}{\partial Q_1} = P_1 - gQ_2 = 0; \frac{\partial L}{\partial Q_2} = P_2 - gQ_1 = 0; \frac{\partial L}{\partial g} = U^o - Q_1Q_2 = 0$$

which give

$$Q_1 = \left(\frac{P_2U^o}{P_1}\right)^{1/2} \text{ and } Q_2 = \left(\frac{P_1U^o}{P_2}\right)^{1/2}$$

the compensated demand curves for goods 1 and 2, respectively. See James M. Henderson and Richard E. Quandt, *Microeconomic Theory* (New York: McGraw Hill, 1980), pp. 20-21.

The amount of compensation that must be paid to the consumer in order to enable him to remain on U_1 when the price of X rises from P_1 to P_2 is given by $\overline{Y}Y^*$. In general, the amount of compensation paid or received that will leave the consumer in his initial welfare position following a change in price is known as "compensating variation".[2] To put it differently, compensating variation measures the change in utility due to a price change in money terms.[3] But this is precisely what the change in consumer's surplus was supposed to represent. It can be shown, but will not be shown here, that compensating variation equals the area to the left of the compensated demand curve between the two prices.[4] In terms of the diagram, $\overline{Y}Y^*$ corresponds to P_1P_2ca. This provides the rationale for the use of compensated demand curves.

In light of the above discussion, we can define excess burden as compensating variation minus tax receipts.[5] In practice the excess burden is often calculated directly by estimating the area of the relevant triangle under the compensated demand curve (eca in Figure 2).

IV. MEASUREMENT OF WELFARE COST OF TAXATION

Suppose that a tax of Tx per unit of good X is levied. Referring to Figure 1 but treating the demand curve as the compensated demand curve, the excess burden of the tax may be expressed algebraically as:

$$W = -\tfrac{1}{2}(P_1 - P_0)(X_0 - X_1)$$
$$= -\tfrac{1}{2}\, dP\, dX \qquad (1)$$

Multiplying and dividing this expression by dP gives

$$-\tfrac{1}{2}\, dP \frac{dX}{dP} dP$$

Now multiplying and dividing by XP^2 and rearranging gives

$$-\tfrac{1}{2}\left(\frac{dX}{dP}\frac{P}{X}\right) XP \left(\frac{dP}{P}\right)^2$$

But $\frac{dX}{dP}\frac{P}{X}$ (to be denoted by e_D) is the compensated elasticity of demand (elasticity of demand of the compensated demand curve) and $\frac{dP}{P} = \frac{Tx}{P_0}$ is the rate of tax (to be denoted by t). The preceding expression may now be written as:

$$W = -\tfrac{1}{2}\, e_D X P t^2 \qquad (2)$$

(1) and (2) are two equivalent formulae for computing the excess burden of a single tax. These partial equilibrium formulations ignore the existence of other taxes. Moreover, frequently we wish to know the welfare gain or loss of increasing or decreasing one tax and changing another tax to keep the tax revenue constant. We, therefore, need a general expression for the excess burden of a given set of taxes. The general expression for the excess burden of N taxes[6] is:

$$W = -\tfrac{1}{2} \sum_{i=1}^{N} \sum_{j=1}^{N} S_{ij} T_i T_j \qquad (3)$$

where $S_{ij} = \left(\frac{\partial X_i}{\partial P_j}\right)_U$ is the compensated derivative of the demand for the ith commodity with respect to the price of the jth commodity,[7] and Ti is the amount of tax per unit of good i.

The general expression can be reduced to (2) in the case of a tax on a single good, as follows:

$$W = -\tfrac{1}{2}\, S_{11} T_1^2 \qquad \text{(since } i = j = 1\text{)}$$

$$= -\tfrac{1}{2}\left(\frac{dX_1}{dP_1}\right)_U (dP_1)^2$$

$$= -\tfrac{1}{2}\left(\frac{dX_1}{dP_1}\right)_U \frac{P_1}{X_1}\frac{X_1}{P_1}(dP_1)^2$$

$$= -\tfrac{1}{2}\left(\frac{dX_1}{dP_1}\right)_U \frac{P_1}{X_1}\frac{X_1}{P_1}\frac{P_1}{P_1}(dP_1)^2$$

$$= -\tfrac{1}{2}\, e_D X_1 P_1 t_1^2 \quad \left(\text{where } t_1 = \frac{dP_1}{P_1}\right)$$

2. For a lucid and more detailed discussion of compensating variation, see Robin W. Boadway, *Public Sector Economics* (Cambridge, Mass.: Winthrop Publishers, Inc., 1979), pp. 47-50.

3. Note that there is no unique measure of utility change in money terms. Equivalent variation could be used instead of compensating variation. See Henderson and Quandt, pp. 49-50.

4. This is not difficult to show using indirect utility functions and expenditure functions, but a discussion of these concepts will take us too far afield. See Henderson and Quandt, pp. 41-45, 49-52.

5. A simple numerical illustration of a compensated demand curve, compensating variation and excess burden will be found in P.B. Dixon, S. Bowles and D. Kendrick, *Notes and Problems in Microeconomic Theory* (Amsterdam: North Holland, 1980), pp. 144-146.

6. The expression is derived in a number of different ways in Arnold C. Harberger, "Taxation, Resource Allocation and Welfare", reprinted in *Taxation and Welfare* (Boston: Little, Brown and Company, 1974), pp. 25-62. It should be noted that one of the assumptions underlying the derivations is that outputs are produced at constant costs.

7. It will be recalled that the relationship between the derivatives of an ordinary (or uncompensated) demand curve and a compensated demand curve is given by the Slutsky equation

$$\frac{\partial X_i}{\partial P_j} = \left(\frac{\partial X_i}{\partial P_j}\right)_{\text{utility = constant}} - X_j\left(\frac{\partial X_i}{\partial y}\right)_{\text{prices = constant}}$$

where X_i = the demand for the ith good, P_j = the price of the jth good and y = income. The expression on the left is the derivative of the ordinary demand curve and the first term on the right is the derivative of the compensated demand curve. We denote the compensated derivative

$$\left(\frac{\partial X_i}{\partial P_j}\right)_{\text{utility = constant}}$$

by S_{ij}. It should be noted for later reference that $S_{ij} = S_{ji}$. For a derivation of the Slutsky equation and its interpretation, see Henderson and Quandt, pp. 25-32.

V. AN APPLICATION

Laidler[8] has estimated the welfare cost of income tax incentives for owner-occupied housing in a simple partial equilibrium framework.[9] The main features of his approach are illustrated in Figure 3. D represents the demand for housing services. S_1 is the supply curve and denotes the marginal private cost of providing housing services. The subsidy given through the tax system lowers the private marginal cost of housing to the levels represented by S_2. As a result of the subsidy, the consumption of housing services expands by Q_0Q_1.

The net loss of welfare is denoted by the shaded triangle fcg. This can be seen as follows. The expanded consumption of housing services increases the consumer surplus by ebcg. But the cost of the subsidy (ebdg) must be set against it to arrive at the net change in welfare. The net loss of welfare is, therefore, given by cdg. Since cdg and fcg are similar triangles, the area of the triangle fcg also gives the welfare loss. We obviously need to know the size of the subsidy and the increase it induces in the quantity of housing in order to estimate the size of welfare loss.

If a homeowner were taxed in the same manner as other investors, his taxable income would be given by:

Taxable income = (GR–PT–D–M–MI)V

where GR = gross rent,
PT = property taxes,
D = depreciation,
M = maintenance, and
MI = mortgage interest,

all expressed as a percentage of the value of the house (V). Taking the numerical values used by Laidler:

Taxable income = (.11–0.015–0.0225–0.0125–0.06)V (4)

This states that if the homeowner were to rent his house, he would have to charge a gross rent of 11% of the value of the house if he is to meet all expenses. However, tax laws in the United States and many other countries permit the homeowner to exclude gross rent from his taxable income and to deduct property taxes and mortgage interest from his other income. Taxable income from owner-occupied housing is, therefore, given by:

$$\begin{aligned}\text{Taxable income} &= (-PT-MI)V \\ &= (-0.015-0.006)V \qquad (5)\end{aligned}$$

Subtracting (5) from (4) would give the reduction in taxable income due to the special tax treatment of owner-occupied housing. Multiplying this reduction in taxable income by the taxpayer's marginal tax rate then gives the tax saving or subsidy associated with the tax incentive for owner-occupied housing. Thus,

$$\begin{aligned}\text{Subsidy} &= t\,(GR-M-D)V \\ &= .26\,(.11-0.0125-0.0225)V \\ &= .26\,(0.75)V \\ &= 0.0195V\end{aligned}$$

where the marginal rate of personal income tax (t) has been taken to be 26%. Hence the amount of the subsidy is \$0.0195 per \$ of the cost of the house, and the rate of subsidy is 17.7% (0.0195V/0.11V).

To estimate the change in the quantity of housing, we need to know the price elasticity of demand for housing and the stock of owner-occupied housing. Laidler used an elasticity of –1.5 for his computations.[10] The value of owner-occupied housing owned by persons in the income group \$10,000 – 15,000 was \$61,956 million. Multiplying the rate of subsidy (17.7%) by elasticity of demand (1.5) will give the percent over-invested in housing of 26.6%. This translates into the amount over-invested in housing of \$13,011 million [(26.6/(100 + 26.6)) x 61,956].

The welfare loss may now be computed as follows:[11]

$$\begin{aligned}W &= 0.5\,\triangle P\,\triangle Q \\ &= 0.5\,(\text{subsidy})\,(\text{amount over-invested}) \\ &= 0.5\,(0.0195)\,(13{,}011) \\ &= \$137\text{ million}\end{aligned}$$

Making similar calculations for other income classes, Laidler arrived at the total welfare cost of the tax concessions for owner-occupiers of \$500 million per annum.

VI. EXCESS BURDEN AND OPTIMAL INDIRECT TAXATION

The concept of excess burden leads naturally to the theory of optimal taxation, and perhaps provides the simplest way of deriving a basic proposition in optimal taxation.[12] Optimal tax rates are defined as the rates that will raise the required revenue by minimizing the excess burden of taxation. We wish to investigate the main characteristic of the structure of optimal indirect taxation. The traditional theory of taxation concluded that an ad valorem tax at a uniform rate on all commodities would minimize the excess burden of taxation. Recent research has shown that this conclusion would only be valid if all final commodities (including leisure) could be taxed. The modern approach is based on the assumption that leisure cannot be taxed. The question that the theory of optimal indirect taxation then poses is: which tax rates will minimize the excess burden of indirect taxation given that a specific amount of revenue must be raised and that at least one commodity cannot be taxed? As will be shown, the answer is that the tax rates should be so chosen that the demand for all taxed commodities is reduced by the same proportion. A single rate for all goods will, therefore, not be optimal.

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8. David Laidler, "Income Tax Incentives for Owner-Occupied Housing", in Arnold Harberger and Martin Bailey (eds.), *The Taxation of Income from Capital* (Washington, D.C.: The Brookings Institution, 1971), pp. 50-76.

9. For studies on excess burdens in the context of two-sector general equilibrium models, see Arnold C. Harberger, "Efficiency Effects of Taxes on Income from Capital", reprinted in *Taxation and Welfare,* pp. 163-170; Michael J. Boskin, "Efficiency Aspects of the Differential Tax Treatment of Market and Household Economic Activity", *Journal of Public Economics,* Vol. 4, No. 1, February 1975, pp. 1-25; and Martin Feldstein, "The Welfare Cost of Capital Income Taxation", *Journal of Political Economy,* Vol. 86, No. 1, part 2, April 1978, pp. S29-S52.

10. Most early studies, including Laidler's, used the elasticity of the ordinary demand curve. For a more recent study using compensated elasticities, see Harvey S. Rosen, "Housing Decisions and the U.S. Income Tax: An Econometric Analysis", *Journal of Public Economics,* Vol. 11, No. 1, February 1979, pp. 1-24.

11. The minus sign vanishes because a subsidy is a negative tax.

12. A simple introduction to optimal taxation will be found in David E. Bradford and Harvey S. Rosen, "The Optimal Taxation of Commodities and Income", *American Economic Review,* Vol. 66, No. 2, May 1976 (Papers and Proceedings, 1975), pp. 94-101.

To find optimal rates of indirect taxes, we minimize (with respect to tax rates):

$$W = -\tfrac{1}{2} \sum_{i=1}^{K} \sum_{j=1}^{K} S_{ij} T_i T_j \qquad K < N$$

$$\text{subject to} \quad \sum_{j=1}^{K} T_j X_j = R$$

where S_{ij} and T have already been defined, X_j = the quantity of the jth good purchased and R = tax revenue. $K<N$ denotes that at least one good cannot be taxed. The constraint (the second expression) simply states that the chosen tax rates must bring revenue equal to R.

We can simplify this problem without loss of generality. First, define $T_i = t_i C_i$, where t_i = percentage rate of tax on the ith good and C_i = the producer's price (cost) for the ith good. The solution will then contain ad valorem rates, which are of greater interest than specific rates (T_i). Second, let producers' prices for all commodities equal 1 (that is $C_i = 1$ for all i). This will simplify the mathematics by reducing the number of symbols. Note that the relationship between the consumers' and producers' prices will be given by $P_i = (1+t_i)C_i = (1+t_i)$, where P_i is the consumer's price for the ith commodity. Third, assume that there are only three commodities, two goods (X_1 and X_2), which can be taxed, and leisure (X_3), which cannot be taxed. This will make it possible to write out all expressions in full, thereby making the derivation clearer.

Our problem now is to minimize:

$$W = -\tfrac{1}{2} \sum_{i=1}^{3} \sum_{j=1}^{3} S_{ij} t_i t_j$$

$$\text{subject to} \quad \sum_{j=1}^{3} t_j X_j = R.$$ [13]

Recalling that $t_3 = 0$ and noting that $S_{12} = S_{21}$, minimization of W subject to the revenue constraint is equivalent to the minimization of the Lagrangean:

$$L = -\tfrac{1}{2}[S_{11}t_1^2 + S_{22}t_1^2 + 2S_{12}t_1t_2] + g[t_1X_1 + t_2X_2 - R]$$

We obtain

$$\frac{\partial L}{\partial t_1} = -[S_{11}t_1 + S_{12}t_2] + g\left[t_1 \frac{\partial X_1}{\partial t_1} + t_2 \frac{\partial X_2}{\partial t_1} + X_1\right] = 0 \qquad (6)$$

$$\frac{\partial L}{\partial t_2} = -[S_{12}t_1 + S_{22}t_2] + g\left[t_1 \frac{\partial X_1}{\partial t_2} + t_2 \frac{\partial X_2}{\partial t_2} + X_2\right] = 0 \qquad (7)$$

The next step is to transform expressions such as $\partial X_i/\partial t_j$ into S_{ij}. This can be done by noting that:

$$\frac{\partial X_i}{\partial t_j} = \frac{\partial X_i}{\partial P_j} \cdot \frac{\partial P_j}{\partial t_j} = \frac{\partial X_i}{\partial P_j} \quad (\text{since } P_j = 1 + t_j)$$

and recalling the Slutsky equation

$$\frac{\partial X_i}{\partial P_j} = S_{ij} - X_j \frac{\partial X_i}{\partial y}$$

Substituting the right hand side of the Slutsky equation for $\partial X_i/\partial t_j$ into (6)

$$-[S_{11}t_1 + S_{12}t_2] + g\left[t_1\left(S_{11} - X_1 \frac{\partial X_1}{\partial y}\right) + t_2\left(S_{12} - X_1 \frac{\partial X_2}{\partial y}\right) + X_1\right] = 0$$

Collecting terms in S_{11} and S_{12},

$$(g-1)[S_{11}t_1 + S_{12}t_2] = g\left[t_1 \frac{\partial X_1}{\partial y} + t_2 \frac{\partial X_2}{\partial y} - 1\right] X_1$$

$$\text{or } S_{11}t_1 + S_{12}t_2 = C X_1 \qquad (8)$$

$$\text{where } C = \frac{g}{g-1}\left(t_1 \frac{\partial X_1}{\partial y} + t_2 \frac{\partial X_2}{\partial y} - 1\right)$$

Similarly (7) can be reduced to:

$$S_{21}t_1 + S_{22}t_2 = C X_2 \qquad (9)$$

(8) gives an estimate of the proportion by which the demand for X_1 would decline as a result of the taxes on X_1 and X_2. (9) states that the demand for X_2 should decline by the same proportion. It follows that (8) and (9) together imply that tax rates should be so chosen that the demand for both X_1 and X_2 declines by the same proportion (along compensated demand curves). This proposition, known as the Ramsey rule, is what we had set out to establish.

A special case of the Ramsey rule arises when the demands are independent (that is, when $S_{12} = S_{21} = 0$). The implications of the solution will be more clearly seen if derivatives are replaced by elasticities, and the amounts of tax payable by ad valorem tax rates. To do this, we divide both sides of (8) by X_1 and multiply the left hand side by P_1/P_1. Similarly, we divide both sides of (9) by X_2 and multiply the left hand side by P_2/P_2. We get

$$\left(\frac{S_{11}P_1}{X_1}\right) \frac{t_1}{P_1} = C \qquad (10)$$

$$\left(\frac{S_{22}P_2}{X_2}\right) \frac{t_2}{P_2} = C \qquad (11)$$

$$\text{But } \frac{S_{ii}P_i}{X_i} = \left(\frac{\partial X_i}{\partial P_i}\right)_U \frac{P_i}{X_i}$$

is nothing but the compensated elasticity of demand for the ith good with respect to its price (to be denoted by e_{ii}) and t_i/P_i is simply the ad valorem rate of tax (amount of tax as a proportion of the gross-of-tax price) for the ith good (to be denoted by r_i). Combining (10) and (11)

$$\frac{r_1}{r_2} = \frac{e_{22}}{e_{11}}$$

In words, this states that the tax rates should be inversely related to (compensated) price elasticities. This result is referred to as the inverse elasticity rule.

13. The derivation given here is suggested by an example in Arnold C. Harberger, "Taxation, Resource Allocation and Welfare", *Taxation and Welfare*, p. 48.

One special case where the conclusion of the traditional theory will hold when leisure cannot be taxed is worth noting.[14] This occurs when the supply of labor (and consequently the consumption of leisure) is fixed. Then, a tax at a uniform rate on all commodities other than leisure will not distort the structure of demand since the relative prices of taxed goods will remain unchanged, and the change in the relative price of leisure and other goods would not matter because the consumption of leisure could not be varied. The assumption that taxes do not affect the work-leisure choice lacks realism, however.

Optimal taxes have been discussed in relation to the allocation of resources. Equity considerations can also be introduced in the framework of optimal taxation.

VII. CONCLUDING REMARKS

The increasing use of welfare cost calculations in applied public finance has stimulated renewed interest in better measures of consumer's surplus.[15] The usefulness of the concept of consumer's surplus for policy purposes has, however, always been surrounded by controversy.[16] The reader alone must, therefore, decide how much importance to attach to excess burden calculations in judging the merits of different tax reform proposals.

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14. We have suggested, but not demonstrated, that a uniform rate of tax would be optimal when all final goods (including leisure) can be taxed. An equivalent expression for (3) when $T_i = t_iC_i$ and $C_i = 1$ is:

$$W = \tfrac{1}{2} \sum_i \sum_{j<i} S_{ij} (t_i - t_j)^2$$

It follows that the welfare loss will be minimum (in this case, nil) when tax rates on all goods (including leisure) are equal. See Arnold C. Harberger, "Taxation, Resource Allocation and Welfare", *Taxation and Welfare,* p. 39.

15. See, especially, Jerry R. Green and Eytan Sheshinski, "Approximating the Efficiency Gain of Tax Reforms", *Journal of Public Economics*, Vol. 11, No. 2, April 1979, pp. 179-196; and Jerry A. Hausman, "Exact Consumer's Surplus and Deadweight Loss", *American Economic Review,* Vol. 71, No. 4, September 1981, pp. 662-676.

16. A useful survey of the controversies is provided in J.M. Currie, J.A. Murphy and A. Schmitz, "The Concept of Economic Surplus and Its Use in Economic Analysis", *The Economic Journal*, Vol. 81, No. 324, December 1971, pp. 741-799.

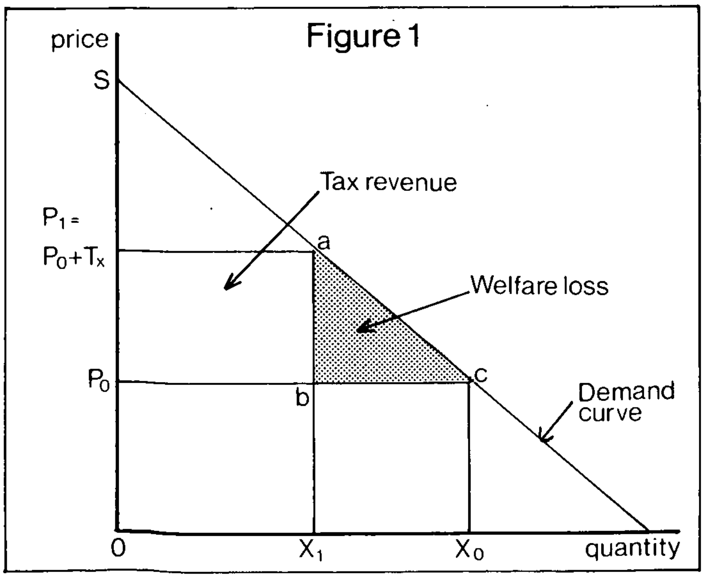

Figure 1

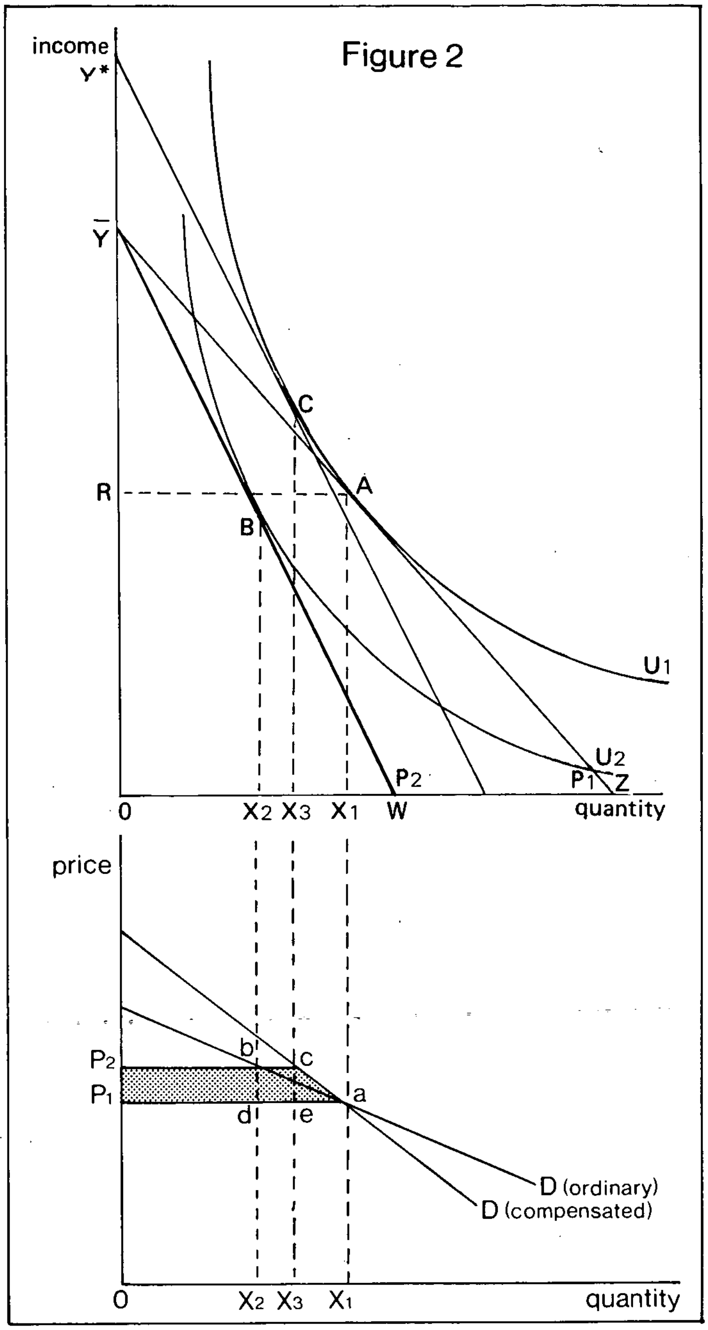

Figure 2

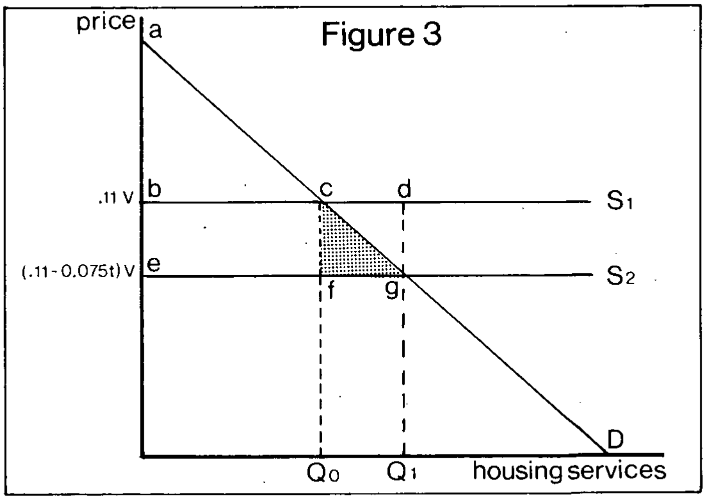

Figure 3

AUSTRALIA:

Avoidance of Income Tax: Trust Stripping *

This statement aims to make clear beyond all doubt that trust stripping schemes can no longer have their intended effect of enabling participants to avoid payment of income tax, and that taxpayers who pay fees to promoters for such schemes are simply wasting their money, as well as making themselves liable to heavy penalty taxes.

The essence of a trust stripping scheme is that income of a family trust is diverted, through a chain of trusts, to persons who are associated with the promoter but who do not pay tax on the income, perhaps because it has been moved off-shore to persons who are not residents of Australia for income tax purposes. The family members enjoy the benefit of the income, less the promoter's fee, in a non-taxable capital form.

Anti-avoidance legislation dealing specifically with these schemes has been enacted, with effect from 12 June 1978, and was the subject of amendments of a strengthening nature, operative from 6 March 1980.

The practical effect of that legislation, where it applies, is to tax the income in the hands of the last trustee in the chain, at the maximum rate of personal income tax, 60%. This basis of taxation accords with the general rule of the income tax law that income of a trust to which no beneficiary is presently entitled is taxed in the trustee's hands at the rate of 60%.

Trust stripping arrangements are also within the scope of the new general anti-avoidance provision of the Income Tax Assessment Act, Part IVA. Under that provision a person is taxed on income which might reasonably be expected, but for a tax avoidance scheme, to have been derived by the person as income subject to income tax. The family members from whom income is diverted under a trust stripping arrangement are accordingly taxed as if they had received the income.

Where Part IVA applies to strike down a tax avoidance scheme, the persons concerned are liable to pay not only the amount of tax sought to be avoided but also additional tax by way of penalty of an additional 200% of the basic tax.

It has recently come to the Government's notice that, despite its resolute attacks on these tax avoidance schemes, some promoters continue to market them. An outline of known features of schemes that have come under notice is contained in an appendix to this statement.

While the Commissioner of Taxation has come into possession of details of a number of such schemes, those who promote them make it their business to keep details away from the tax authorities and even, in some critical respects, away from taxpayers to whom the schemes are offered. Their aim in doing this is to delay administrative consideration of the schemes for as long as possible and the payment of tax ulimately found to be payable. It is because of this reticence that some of the examples in the appendix are sketchy.

The attempted exploitation involved in all of these schemes is blatant. A legal opinion used to assist in marketing the first of the schemes runs to some 54 pages and discusses at length the possible obstacles to the success of the scheme.

In discussing the possible impact of Part IVA, counsel writes:

> "The present proposal clearly involves a 'scheme' as defined, and it will be one entered into after 27 May 1981. It is hard to contest the view that it 'would be concluded', after considering the various matters listed in section 177D, that the dominant purpose of those who entered into it and carried it out was to effect a tax saving for the client group. But not all tax savings or adventages are within the definition of 'tax benefit'. For the Part to have an adverse effect upon [the client's trust] or any member of the client group it is necessary for the Commissioner to nominate a particular taxpayer, and a particular amount of assessable income which amount 'would have been included, or might reasonably be expected to have been included' in the assessable income of that taxpayer: section 177C(a). It is only where that can be done that the Part enables the Commissioner to assess."

While in this and other opinions on the matter, counsel put a number of arguments to the effect that the specific and general anti-avoidance provisions do not apply, the key line of argument is that it cannot be said in a number of cases that, but for the scheme, an amount would or might reasonably be expected to have been included in a particular beneficiary's assessable income.

The Government has sought the advice of the Commissioner of Taxation about the likely efficacy of the latest schemes. The Commissioner is strongly of the view that the courts will uphold his contention that it is practicable to find the identity of the persons who would have derived the income, or might reasonably be expected to have derived it, but for the scheme. On that basis there could on one view of things be no need for Government action – in due course persons concerned will be liable to pay the tax along with the penalty tax.

However, the fact remains that promoters are blatantly offering these schemes for sale. Equally, the Government cannot accept that such schemes should have even the remotest chance of success, either to escape payment of tax altogether or to defer its payment until after the process of appeals has been concluded.

The Government has considered whether Part IVA should be amended, but has concluded that it should not. The central test – whether there is an omission of income that otherwise might reasonably be expected to have been included in the taxpayer's assessable income – is, in the Government's view, a correct one. To express it in other terms would probably involve conferring on the Commissioner of Taxation the onerous responsibility of selecting, on a discretionary basis, the person to be

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* Statement of 11 May 1982 by the Treasurer, the Hon. John Howard, M.P.

taxed. That, in the Government's view, is the least attractive of the possible options.

Rather than adopt such a course, the Government intends to follow a procedure it has followed in relation to what have become known as "expenditure recoupment" schemes of tax avoidance. I indicated in a statement on 24 September 1978 that if further "expenditure recoupment" schemes were to surface, remedial legislation would be brought forward and be effective from that day. The Government has on subsequent occasions given effect to this warning, the most recent occasion being that of my statement of 9 February 1982 about certain tax rebate schemes of the "expenditure recoupment" type.

Accordingly, I now announce that, should existing legislation be found inadequate to strike down any scheme of the trust stripping type, the Government will introduce appropriate remedial legislation. That legislation will have effect after today, that is, it will apply to trust income of the current and subsequent income years, except where the income has been paid to or applied for the benefit of a beneficiary before tomorrow. The legislation will be structured so that tax is borne by the persons who are found to have rights to effectively enjoy the income, whether in a capital form or in any other way. Depending on the structure of the particular schemes, collection of the tax could be from beneficiaries, trustees or any other participants.

Although this action will make it certain that the tax will be paid, participants in trust stripping schemes cannot be allowed to have the advantage of a postponement of the time of payment of the tax. Therefore, I also make it clear that any legislation that it becomes necessary to propose will in addition make the people concerned liable to pay as penalty tax an amount at least as great as that which applies at present under Part IVA.

This statement is a clear and unambiguous warning as to the Government's intention in this matter.

Appendix to Treasurer's Statement of 11 May 1982

Trust strip using Australian and overseas trusts (1)

- The client's family trust makes a distribution of its income to a trust controlled by the promoter which, in turn, distributes the income to a third trust also controlled by the promoter.
- The trustee of the third trust distributes an amount representing the promoter's fee to a further trust controlled by the promoter. The trustee then resolves to hold the balance of its income for the benefit of an Australian unit trust, with the claimed result that the unit trust will in turn be deemed to be presently entitled to that income.
- The trustee of the third trust then enters into arrangements designed to ensure that the amount of the income, net of the promoter's fee, is in reality retained by the client's family trust. This is achieved by the trustee of the third trust lending the equivalent amount, in exchange for a promissory note, to a trust controlled by the client. That trust then uses the funds represented by the loan to purchase assets from the client's original family trust.
- The income to which the Australian unit trust has been made presently entitled (net of the "fee" distribution to the promoter's trust) is, without funds ever leaving Australia, successively applied for the benefit of six trusts each of which is established in Nauru. The income is accumulated in the sixth Nauruan trust.
- It is claimed that the income is no longer attributable to Australian sources. However, in the event that that claim is not successful and section 100A of the Income Tax Assessment Act applies to deem the trustee of the sixth Nauruan trust not to be presently entitled to the income a further mechanism is built into the scheme with a view to ensuring that the trustee of the fifth Nauruan trust is not subject to assessment under section 99A of the Act.
- Under this, a United Kingdom company becomes entitled to the income of the fifth Nauruan trust in the event that the trustee of that trust does not exercise its discretion to apply income for the benefit of the sixth Nauruan trust (i.e. in the event that section 100A applies to deem the sixth Nauruan trust not to be presently entitled to the income). The resultant income of the U.K. company is claimed to be exempt from Australian tax under the double taxation agreement with the U.K. by virtue of the income being "industrial or commercial profits" not attributable to a permanent establishment in Australia. The income is said not to be subject to tax in the U.K. as it is a fictitious entitlement to income that arises solely by the operation of Australian tax law.
- The final stages of the arrangements involve the sixth Nauruan trust lending an amount equal to the accumulated income to a seventh Nauruan trust which then subscribes for units in an eighth Nauruan trust which, in turn, settles the amount on a ninth Nauruan trust, which is capable of being controlled by the client.
- Ultimate beneficial entitlement to the funds represented by the promissory note issued by the client's second trust ends up with the ninth Nauruan trust and arrangements are made so that if the promissory note is presented to the client's trust for payment the client is able to obtain practical control of the trust.

Trust strip using Australian and overseas trusts (2)

- The scheme promoter's finance company makes a loan to an Australian discretionary trust controlled by the promoter by accepting a demand bill.
- The promoter's discretionary trust purchases units in the promoter's fixed unit trust by endorsing the bill to that trust.
- The promoter's fixed unit trust purchases – by further endorsement of the bill – special limited income units in a Northern Territory unit trust presently controlled by the taxpayer through a related discretionary trust holding a controlling interest in ordinary units. The limited income units are capable of being converted to ordinary units by a specified date.
- The Northern Territory unit trust then makes a loan to the client's operating trust, the income of which is to be stripped, by further endorsing the bill.
- The client's operating trust (which in the case of "in-house" arrangements may be the promoter's own trust having income that flows to it under other avoidance arrangements) then distributes its income down a chain of Australian trusts to the promoter's discretionary trust by further endorsements of the bill. The promoter's discretionary trust then repays its debt to the finance company by endorsing the bill.

- The preceding steps complete a round-robin, the result of which is to ensure that the amount of the income of the operating trust is retained by the trust. As part of the scheme, the right of conversion attaching to the limited income units held by the promoter's unit trust lapses, ensuring that control of the Northern Territory unit trust (and so of the outstanding debt of the client's operating trust in respect of the loan) is retained by the client.
- An Australian unit trust is then made presently entitled to the income of the promoter's discretionary trust, which is represented by its present entitlement from the preceding trust in the chain.
- The present entitlement is then passed down through a number of foreign trusts to a Canadian resident. Again it is claimed that the income is no longer attributable to sources in Australia. The arrangements also incorporate the use of "secondary beneficiaries", similar in nature to those under the preceding scheme.
- The Canadian entity assigns its right to the trust income to a Nauru trust which gifts the right to the income to the promoter's fixed unit trust. This step is designed to ensure that the Australian unit trust and the trusts in the foreign chain are presently entitled to the relevant trust income.

Trust strip using Australian and overseas trusts (3)

- The client's operating trust (which again, under certain "in-house" arrangements, may be the promoter's own trust) distributes its income in the form of a bill of exchange through a chain of Australian trusts associated with the promoter.
- The last Australian trust assigns the bill of exchange to a discretionary trust (controlled by the taxpayer) in exchange for an unsecured note. The discretionary trust makes a loan to the operating trust by endorsing the bill of exchange in its favour.
- The effect of these arrangements is to complete a round-robin, by which money represented by the bill of exchange remains with the client's operating trust.
- The last Australian trust resolves to distribute the income to a tax haven trust in Nauru and holds the unsecured note for that trust.
- The tax haven trust sells its interest in the unsecured note to a second Nauru trust which in turn sells the note to a foreign company controlled by the client, or associates of the client, ensuring that there is no outstanding liability on the part of the client. The net result of this and the round-robin of the bill of exchange is to ensure that the amount of the income is in reality retained by the client's operating trust.
- The tax haven trust borrows from an associated tax haven trust and distributions of income in the form of a bill of exchange occur down a chain of foreign trusts. It is claimed that the income is no longer attributable to sources in Australia or, if that claim is not successful, that the income is exempt from Australian tax by virtue of the "business profits" article of Australia's double taxation agreement with Canada – the country of residence of the last two entities in the chain.
- The final entity in the foreign chain – a Canadian company – claims to avoid any liability to tax in that country offsetting assessable trust distributions by deductible interest payments which arise as part of the scheme. In addition no Canadian interest withholding tax is said to be payable because of the terms of the particular loan agreements.
- The off-shore arrangements, including the interest commitments, are financed by a complex series of round-robin transactions using a tax haven company.
- The client's operating trust passes a fee to the promoter by way of a second and parallel set of trust distributions down a second trust chain.

Trust/gift distribution scheme

- The operating discretionary trust distributes its income to a related discretionary trust, the beneficiaries of which are the same or substantially the same as those of the operating trust.
- The related trust invests the whole of the amount of the income in subscribing for special "A" class redeemable preference shares in a newly established private investment company, thereby acquiring control of that company.
- The company then lends an amount equivalent to the amount subscribed for the shares back to the operating trust.
- The preceding steps complete a round-robin, the net result of which is that the income of the operating trust is in reality retained by that trust.
- The beneficiaries of the related trust are made presently entitled to the income of the trust (now represented by the special "A" class redeemable preference shares), subject to their using that present entitlement to acquire the preference shares.
- The beneficiaries are "invited" to donate those shares to a charity, gifts to which are deductible for income tax purposes. The deduction claimed in respect of the gift is equal to the amount of the assessable trust distribution.

Trust strip through use of charitable trusts

- The client's discretionary trust distributes its income to a trust controlled by the promoter. The beneficiaries of that trust are the unborn children of the client and a further trust controlled by the promoter.
- The promoter's trust then distributes the income to the second trust controlled by the promoter, which in turn distributes the income to a "charitable trust".
- The charitable trust distributes the income to a second "charitable trust", the income of which is claimed to be exempt from income tax.
- The second charitable trust distributes a minor part of the trust income to a charity. The major part of the income is distributed to a specied individual beneficiary. It is claimed that the income from the exempt trust retains its exempt character in the hands of the beneficiary.
- A separate promoter entity reimburses the client's discretionary trust by way of a collapsible loan, i.e. a loan not intended to be repaid.

Family trust stripping scheme

- The trustee of a new discretionary trust is introduced as a beneficiary of a family trust.
- The initial beneficiaries of the new discretionary trust are the family members and the trustee of a trust controlled by the promoter.

- Subsequently, the family members are excluded as beneficiaries both of the family trust and of the new discretionary trust.
- The original family trust then derives income from a distribution from a family company, which is in turn distributed to the new discretionary trust.
- The new discretionary trust then enters into arrangements designed to return the amount of the income to the family. These involve the trustee subscribing for special redeemable preference shares in a company, which are subsequently forfeited. The company then reimburses the family interest, either directly by the settlement of trusts for the benefit of the family members, or by settlements in favour of an associate which will acquire (and forfeit) redeemable preference shares in a company controlled by the family group.
- A further promoter's unit trust is then made "presently entitled" to the income of the new discretionary trust, which is represented by its present entitlement to the original family trust's income.
- The second promoter's unit trust "deals" with the distribution in ways that have not been disclosed.

Conference Diary

NOVEMBER 1982

Management Centre Europe: 11th International Finance Conference: Changes in international finance and their implications for business (including: Financial and tax incentives aimed at attracting investments). Geneva (Switzerland), November 3-5 (English).

Horizon International Tax Management: Tax and legal counseling for the foreign client (Seminar). Los Angeles California (U.S.A.), November 5 (English).

International Tax Planning Association: Singapore Seminar (including: South East Asia as a base for international transactions; current developments in international tax planning). Singapore (Republic of Singapore), November 10-12 (English).

Management Centre Europe: Leasing; techniques and analyses (including: Tax aspects of leasing). Brussels (Belgium), November 17-19 (English).

Tax Affairs Foundation of the Philippines: 2nd International Tax Convention. Singapore (Republic of Singapore), November 26-30 (English).

Steuer-Telex-Seminar: International Tax Law; (in particular business relations between Germany and Austria from a tax point of view). Vienna (Austria), November 19-20 (German).

DECEMBER 1982

Management Centre Europe: Taxation of International Group Companies and Branches (including: Taxation of branches and subsidiaries; taxation of shareholders; domestic and tax treaty "anti-avoidance" measures) (Seminar). Brussels (Belgium), December 2-3 (English).

Terzake Belastingen: Tax aspects of Doing International Business. Amsterdam (Netherlands), December 2 (Dutch).

Management Centre Europe: International cash management (including: International tax aspects in cash management). London (United Kingdom), December 6-8 (English).

Management Centre Europe: Stanley B. Lubman on China (including: The joint venture income tax law; the tax on individual income; the tax on foreign enterprises; recent regulations and interpretations by central and local tax authorities). Brussels (Belgium), December 9-10 (English).

U.K. Tax Congress: 2nd Annual U.K. Tax Congress (including: Current uses of U.K. offshore tax havens; taxation of commercial interest; tax deferral opportunities for individuals). London (United Kingdom), December 9-10 (English).

OCTOBER 1983

The Taxation Institute of Australia: Sixth National Convention (including: The role of the High Court in interpreting tax statutes; taxation of technology; tax shelters and planning for the '80s). Melbourne (Australia), April 10-15 (English).

37th Annual Congress of I.F.A.: I. Tax avoidance/tax evasion. II. International problems in the field of turnover taxation. Venice (Italy), October 10-15 (English, French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

Horizon International Tax Management, Ltd.: 410 Linden Road, Bellingham, Washington 98225 (U.S.A.).

International Tax Planning Association: 33A Warwick Square, London SW1V 2AD (United Kingdom).

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.

Steuer-Telex-Seminar: Dr. Peter Deubner Verlag GmbH, Abteilung Seminare. Postfach 410268. 5000 Köln 41 (Federal Republic of Germany).

Tax Affairs Foundation of the Philippines, Inc.: 32 Catanduanes Street - West Avenue (near the Mobil gas station) Quezon City. P.O. Box 100 PA, Manila (Philippines).

Terzake Belastingen: VNU Data publishing International bv. Antwoordnummer 18007, 1000 VB Amsterdam (Netherlands).

The Taxation Institute of Australia: 113 Swanson Street, Melbourne VIC. 3000 (Australia).

U.K. Tax Congress: 20 London Road, Horsham, West Sussex RH12 1AY (United Kingdom).

IFA NEWS

In memoriam

Professor Dr. J.C.L. Huiskamp

IFA announces with great sorrow the untimely death of its Assistant Secretary General, Professor Dr. J.C.L. Huiskamp, on 13 September 1982. His health had been indifferent during the last years but this did not prevent him from accomplishing the many tasks he imposed on himself. IFA is in particular grateful for the work he performed on its behalf.

Professor Huiskamp started his career in 1952 as a research associate with the International Bureau of Fiscal Documentation, where he worked with an interruption of some time for 15 years. He was the Editor-in-Chief of the *Bulletin for International Fiscal Documentation* and in 1967 he became one of the Bureau's deputy directors. In 1971 he left the Bureau and accepted a post as associate professor at the Erasmus University in Rotterdam and deputy director of the *Institute for Fiscal Studies*. Later he became a full professor and the director of that Institute.

His friends know that Joop Huiskamp had many adversities in his life and that only in the last few years did he again find happiness with his wife Lenie. We all mourn a dear friend whose capability and integrity were above question.

Some Highlights from the Secretary General's 1981-82 Report Presented at the Montreal Congress 1982

BERLIN CONGRESS 1981

The 35th Congress of IFA took place in September 1981 in the International Congress in West Berlin under the supervision of Dr. Karl Beusch, Chairman of the German Branch of IFA, assisted by Mr. Arnold Willemsen and Dr. Karl-Dieter Wingert.

With respect to Subject I – "Mutual agreement – Procedure and practice" – Prof. Dr. H. List (Federal Republic of Germany) acted as Chairman of the Working Session, Prof. Dr. P. Fontaneau (France) as discussion leader, Dr. K. Koch (Federal Republic of Germany) as General Reporter and Messrs. P.E. Coates (U.S.A.), J. de la Villa Gil (Spain), D.A. Ward (Canada) and J. Westenburgen (Netherlands) as panelists.

With respect to Subject II – "Unilateral measures to prevent double taxation" – it was Mr. J. Olinger (Luxembourg) who acted as Chairman, Prof. Dr. E. Höhn (Switzerland) as discussion leader, Dr. D. Juch (Netherlands) as General Reporter and Messrs. A. Timbart (France), G. Hill (Australia), R. Aguirre (Mexico) and H. Roe (United Kingdom) as panelists.

Chairman of the Seminar on "Taxation of the income arising from the international seabed" was Prof. Dr. K. Vogel (Federal Republic of Germany) and panelists were Messrs. C.M. Bruce (U.S.A.), Dr. P. Kirthisingha (UNCTAD), Dr. K. Oetting (Federal Republic of Germany) and Mr. J.C. Delespaul (France). These gentlemen were also instrumental in writing background papers to the Seminar provided to the participants in their congress kits.

MITCHELL B. CARROLL PRIZE

Dr. Moris Lehner (Federal Republic of Germany) won the Mitchell B. Carroll Prize 1981 for his work entitled *Möglichkeiten zur Verbesserung des Verständigungsverfahrens auf der Gundlage des EWG-Vertrages* (Possibilities of improving the mutual agreement procedure within the scope of the EEC Treaty).[1]

1. See 35 *Bulletin for International Fiscal Documentation* (1981) at 519.

IFA OFFICERS COME AND GO

The Executive Committee regretfully announces the premature death of its member, Dr. Robert Bechinie, Chairman of the Austrian Branch. Two new members were appointed: Mr. M. Marin Arias (Spain) and Mr. R. Koch-Nielsen (Denmark). Dr. Antal (Netherlands) was replaced by Prof. A. Nooteboom, currently the Chairman of the Dutch Branch.

Mr. Graeme Herring (Australia) will be due for statutory retirement at the Montreal Congress.

NATIONAL BRANCHES

At the Berlin Congress the Singapore Branch was recognized. Sri Lanka is also interested in forming a branch and Mr. Ambalavaner has submitted a draft constitution for approval. A number of branches have faithfully sent reports on their branch activities and it is hoped that other branches will follow suit. There have been a number of bilateral meetings, e.g. the Belgo-Luxembourg Branch held a joint seminar with the German Branch.

MEMBERSHIP FEES

IFA will recommend – for the second consecutive year – not to increase the membership fees for 1982-83. Thus they will remain:

- US$ 38 for individual members of IFA branches;
- US$ 40 for direct individual members of IFA;
- US$ 90 for corporate members, both direct and of national branches.

MONTREAL CONGRESS 1982

At the time of writing the 1981-82 Report, preparations for the Montreal Congress were nearing completion. General Reporters are Prof. E. Höhn (Switzerland) and Me. G. Coulombe (Canada) for Subject I and Subject II respectively. The discussion leader will be Mr. R.M. Hammer (U.S.A.) and Prof. I. Claeys Bouuaert (Belgium). The Chairmen of the Resolutions Committees are Prof. Dr. H. Vogel (German Federal Republic) and Dr. R. Casas (Mexico).

The Seminar to be organized by IFA will have as its subject "Imputation Systems – Objectives and Consequences", and it will be chaired by Mr. D.A. Ward (Canada). Panelists will be Mr. P. den Boer (Netherlands), Mr. D.R. Tillinghast (U.S.A.), Dr. S. Mayr (Italy), Mr. S. Wright (U.K.), Mr. S. Poddar (Canada), Dr. P. Franken (German Federal Republic), Prof. P. Fontaneau (France), and Mr. A. Buelinckx (Belgium).

The Canadian Branch will organize two seminars, one on the Canadian tax system and one on the draft Canadian–U.S.A. tax treaty. Booklets containing background information will be prepared by Canadian tax experts.

FUTURE CONGRESSES

1. Venice Congress 1983

During its spring meeting the Permanent Scientific Committee discussed the directives for the Venice Congress. The subjects are:

Subject I: Tax avoidance/Tax evasion.
General Reporter: Prof. V. Uckmar (Italy).

Subject II: International problems in the field of general taxes on sales of goods and services.
General Reporter: Prof. DDr. H.G. Ruppe (Austria).

2. BUENOS AIRES CONGRESS 1984

The subjects which were selected for the Buenos Aires Congress are:

Subject I: Tax factors affecting the international flow of capital between the parent and its subsidiary.
The General Reportership is still under discussion, and will be known finally during the Montreal Congress.

Subject II: Social security contributions as a tax factor for enterprises engaged in international activities.
General Reporters: Profs. E.J. Reig and J. Macón (Argentina).

COLOMBIAN BRANCH OF IFA

Recent activities

The Colombian Branch of IFA currently has 41 active members including many leading experts in tax matters. Since June 1981 the Executive Committee has accepted five new members who have had a distinguished career in taxation. Some of its active members have been called upon to serve their country in high positions. For instance, Dr. Bernardo Ortiz has recently been appointed President of the Council of State and Dr. Simón Rodríguez President of the Administrative Court of Cundinamarca. The present National Director of Taxes has also been a member of IFA for serveral years. In addition, the Colombian Branch includes a number of former Finance Ministers, former directors of taxes and leading lawyers and professors specialized in taxation and public finance among its members.

The Executive Committee, which was appointed in June 1981, considered the legal regime for foreign investments of utmost importance and therefore focussed its efforts on organizing a seminar on this subject. This seminar was held on 26 February 1982 and lasted 10 hours and attracted 80 participants. Papers were read by five members of the Colombian Branch on the following subjects:

- The development of the institutional framework and foreign investment policy;
- Legal and exchange regimes;
- Tax treatment of profits; accounting and tax relations with the head office;

- Technical assistance and services, know-how and royalties;
- Public contracting – consortia and their tax treatment.

Other activities included the organizing of luncheon meetings which were devoted to the discussion of selected subjects. At one of these meetings members of the Bird-Wiesner Commission were invited to discuss a number of interesting issues dealt within their report on public finance which was prepared at the request of the national government. In November 1981, Dr. Carlos Ramírez presented his report on the "Tax treatment of interest in international economic transactions" which he prepared for the Montreal Congress.

These luncheons serve, in addition, to inform the members on subjects selected for future IFA congresses as well as to examine and comment on other activities of the Colombian Branch. A special task undertaken by the Branch is the publication of a bibliography and articles on tax subjects, including comparative tax law. For this purpose the *Bulletin for international fiscal documentation* has been of valuable assistance. Unfortunately, however, due to language barriers, these articles cannot be as widely distributed and used as they deserve.

MALAYSIAN BRANCH

On 11 June 1982 the Malaysian Branch of IFA held its inaugural meeting. On that occasion, Mr. Angel Q. Yoingco, Director of the National Tax Research Center, Republic of the Philippines, delivered a talk on Regional Cooperation in Taxation. *The major part of this talk is reproduced here.*

It does feel grand to be given the honor of being the guest speaker for the inaugural luncheon meeting of the Malaysian chapter of the *International Fiscal Association*. In the Philippines, we term this privilege as "buena mano." In commercial parlance, he is the first morning buyer. Normally, he is supposed to bring good luck to the business. I hope I brought all the luck with me. It may interest you to know, that I have a high batting average when it comes to being a lucky "buena mano."

I cannot help but entertain some suspicions however, on why I was extended this invitation by Mr. Lee Beng Fye, Secretary General of 12th SGATAR meeting and Tan Sri Lim Leong Seng, former Director General of your Tax Department and now Chairman of IFA, Malaysian chapter. Let me reflect aloud on two possible reasons.

First, being Mr. Lee Beng Fye's personal friend, I strongly suspect that he virtually pressured you in having his friend as the guest speaker.

Second, I would like to think that being the only participant who has been with the Study Group on Asian Tax Administration and Research (SGATAR) from the day it was conceived in 1970 until today, gives me enough experience to speak before a group of learned men.

Given the prerogative to make the choice, I shall take the last reason as the most plausible rationale why you have invited me. It is also for this reason why I chose to speak on a topic that is close to my heart and is of concern and interest to you: *Regional Cooperation in Taxation*. Let me warn you at this point that my ghost writer differed in his opinion of what I should talk about. Thus, he prepared a speech for me on an entirely different topic. I was therefore left on my own to prepare my short discourse for this afternoon.

The opening remarks of the Mayor of Copenhagen to the 1979 IFA meeting lucidly summarized the dilemma of many developing countries: The appetite of the public for paying taxes is not as strong as their demand for government services. Governments constantly face the problem of financing their continuously rising budgets. Quite commonly this situation will be met either through the increase in existing tax rates or through the enactment of new taxes. This process cannot go on indefinitely as there is a limit to taxation. At some point in time, taxation will affect incentives to work and invest. Already, we witness an evidence of people's aversion to taxes through non-compliance with tax laws. Policy makers must therefore find other avenues to increase the productivity of their tax systems. It is along this need that regional cooperation in taxation aside from bilateral tax treaties finds relevance. Through regional organizations countries can share information on tax policies, practices and experiences. They can also provide a forum where policy makers and administrators can learn from one another through study groups and regular meetings especially with regard to the improvement of tax administration.

A more concerted effort is also needed in confronting the problem of taxing multinational companies effectively. Given the lack of resources to adequately check the financial records of these corporations, countries, especially developing ones, should get more organized to draw up tax laws and measures to face the MNC's strategies in minimizing tax liabilities like the use of tax havens.

The other area calling for regional cooperation in taxation is the needed tax coordination for the elimination of trade barriers and the promotion of investments through the tax instrument. EEC countries for example tend to harmonize their tax laws to promote the free flow of goods and services in the region.

Among others, these could have spurred the organization of regional tax organizations. For the 20 Latin and American countries, there is the Centro Interamericano de Administradores Tributarios (CIAT) which was organized in 1967. The Caribbean Organization for Tax Administrators (COTA) organized in 1970 services the needs of countries in the Caribbean like Jamaica and the Dominican Republic. For members of the Commonwealth, the Commonwealth Association of Tax Administrators (CATA) has recently been founded. In Asia and the Pacific, we are proud of the SGATAR which had its first meeting in Manila in 1971.

A cursory look at the charters of these organizations reveal that they have common objectives. They purport to improve tax administration in member countries through the mutual exchange of ideas and experiences; they aim to promote tax research and the conduct of studies on the various tax systems. They are also intended to review and exchange information about the tax policies and tax structures of member countries.

The fact that the said regional organizations have continued to function justifies their existence. I can speak more easily on SGATAR because I have seen it grow and mature. Although the structure of its membership has changed due to political developments in the region, the SGATAR now boasts of nine member countries as follows: Australia, Indonesia, Japan, Republic of Korea, Malaysia, New Zealand, Philippines, Singapore and Thailand. The SGATAR has provided an appropriate venue for cooperation and discussion in taxation among these member countries. In its annual meetings, member countries have freely discussed their ideas, practices and experiences on about 41 major topics in taxation such as direct taxation, incentive taxation and tax administration.

The problem of tax evasion has been discussed in almost three meetings. In the 1979 Manila meeting, the member countries identified the following as the most common forms of tax evasion:

1. Unreported income of taxpayers through non-filing of returns, omission of certain types of income like dividends and interest.
2. Understatement of income through reduction in or non-recording of sales and incorrect accounts.
3. Improper and unallowable deductions; and
4. False allocation of income through, among others, false charges for salaries and diversions to fictitious partners.

Member countries exchanged experiences in coping with evasion practices. Indonesia and Malaysia conduct inspection of business and residential premises, as well as examination of books of accounts. Japan resorts to auditing of books and other evidential documents, books of the taxpayer's business counterparts and simultaneous auditing of the head office and its branches. New Zealand and Japan use counterpart audit of bank accounts to check cases of tax fraud.

In the 1978 Wellington meeting, member countries acknowledged common problems with regard to the taxation of multi-national corporations. The difficulties as shared were mainly brought about by the following factors:

1. Insufficient information held by the resident company or subsidiary on the methods applied by the overseas parent company in fixing prices and other charges;
2. Lack of expertise on the part of tax officials in handling tax audits and investigations;
3. Inadequate comparative information, particularly where the MNC is in a monopoly situation; and
4. The processing of accounting information through highly sophisticated computer systems which are programmed and controlled within the parent company's country of residence.

To overcome the above problems, most SGATAR countries employ the "arm's length" method in determining the taxable income of MNC's. This means that the profit ratios expected are those that would have been derived had the parties to the tansactions been independent. Another technique employed by participating countries is the introduction of withholding tax systems at source with respect to payment of interest, dividends, and royalties to the parent companies. The Wellington meeting ended with an agreement of the need for greater cooperation and discussion among them in the exchange of information relative to MNC's.

The grant of fiscal incentives has also been a favorite topic for discussion in SGATAR as it has been studied in about three meetings. The dynamism of SGATAR and its response to the changing needs of the countries within the region are evident on the changing concept about tax incentives. In the 1971 Manila meeting, the participating countries were unanimous in acknowledging that fiscal incentives contribute to economic development by attracting investments into those areas which need to be developed. A minority pointed out however the disadvantages of granting liberal incentives which could cause, among others, undue competition among developing countries, in particular. This thinking became more pronounced in the 1975 Bangkok meeting. The delegates generally recognized that all concessions and incentives should be open to review and change with clearly stated time limits on measures such as tax holidays and deferred tax payments. It was also recognized that if all countries in the region were to use fiscal measures to promote exports, a conflict of interest may arise where two or more countries are exporting the same product. The 1975 meeting cautioned that developing countries should not compete excessively with one another in the grant of export concessions.

The attitude towards fiscal incentives radically changed in the 1980 Jakarta meeting. Some participants especially those from Singapore expressed doubt on the effectiveness of fiscal incentives in encouraging development and in attracting foreign investments. Malaysia and Japan could not say with certainty as to the extent the locational incentive was contributory to industrial development. The meeting concluded with the need of member countries to review their respective investment schemes.

Regional meetings in taxation such as the SGATAR do not only end up in conclusions and recommendations. The latter only serve as spring-boards in the introduction of improvements in the tax system of the participating country. They also serve as stimuli for regional projects and activities. Allow me to illustrate both.

1. An instance where one country learns from another is typified in the expansion of the tax withholding system of the Philippines. I have no doubt that the discussion of the Japanese withholding system during the 1976 Singapore meeting has given new insights to the Philippine participants. The Japanese delegation explained a comprehensive withholding scheme in Japan which covers wages, retirement allowances, interest, dividend and remunerations for almost every type of profession. The scheme as mentioned reduces administrative and compliance costs as well as assures a steady flow of government revenues.

The Philippine government introduced the expanded withholding system in 1978 which is similar in many respects to the Japanese system. Various forms of incomes are subject to a withholding tax ranging from 2½ to 35%. A feature has been added, however, in that the withheld tax is creditable.

2. The SGATAR has had opportunities for regional projects. Joint undertakings have been quite successful because of the cooperation of member countries. To date, SGATAR, has completed three publications which contain basic information about the tax systems in the region:

a. The *Glossary of Tax Terms* which is a handy compendium of the definitions of tax terms and phrases commonly used in SGATAR countries. It is intended to serve as a convenient reference material in international conferences, tax treaties and research studies.
b. The *Tax Systems of Selected Countries in Asia and the Pacific* is a synopsis of the tax systems in each of the SGATAR member countries and is aimed at providing information to investors, public officials, members of the academe and students.
c. The *Tax Administration Procedures of Selected Countries in Asia and the Pacific* analyzes the various stages of tax administration procedures in SGATAR countries and recommends measures to improve the efficiency in tax administration.

Cooperation among member countries has also been conducted informally. We have had chances of sending our personnel to train in taxation in other countries, such as in Singapore. The Philippine government, my office in particular, has also invited some of the tax personnel from SGATAR member countries including some junior tax officials from Malaysia to share our experience in policy formulation and research.

There are various areas in taxation through which countries in the region can help one another. SGATAR is one of the more effective tools for harnessing regional cooperation. It was in fact in the 1974 Malaysian meeting that the decision to continue SGATAR was firmed up due to the following reasons:

1. Immeasurable benefits are derived from the exchange of information among participating countries.
2. SGATAR meetings are opportunities for member countries to a) discuss problems and their possible solutions; b) keep abreast of new tax legislations and developments in other countries; c) share their experiences.

It is along these reasons that your chapter, the Malaysian IFA, International Fiscal Association, is looked upon with significance. In the IFA, you will study international and comparative law in regard to public finance. In connection with this objective, the birth of the Asian Pacific Tax and Investment Research Centre (APTIRC) based in Singapore is of common concern to us.

The speaker then went on by mentioning the International Bureau of Fiscal Documentation based in Amsterdam and founded by the IFA in 1938. The Bureau, so Mr. Yoingco said, is involved in the setting up of a similar research institution in Singapore. Mr. Yoingco, who is a member of that institution's founding committee, outlined some of the activities it may perform once it is established. He then continued:

Given your interest in fiscal matters not only in Malaysia but in Asia and the Pacific, I am positive that you will find APTIRC's objectives complementary to yours and its services as relevant to your needs. Prof. van Hoorn, in fact wishes your association success in a message to you which he requested me to relay. Let me quote a part of it:

On behalf of the International Bureau of Fiscal Documentation, a "child" of IFA born shortly after its mother's birth, I wish to congratulate the Malaysian chapter and to extend to all members my cordial greetings. The Bureau was originally meant to serve the members of the IFA. Now, it has a much broader objective, but my colleagues and I shall be at your disposal whenever you need our assistance. As a first token of friendship, I gave instructions to send to each member listed in the Yearbook of IFA a copy of the Bureau's annual report 1981. If it has not yet arrived, it should reach you shortly.

I wish the branch and each member a successful future in the field of our common interest.

In a way, I am more privileged than Prof. van Hoorn as I have this opportunity to personally wish all of you and the IFA, Malaysian chapter, success in all your undertakings. I hope that through a short discussion of the significance of regional cooperation in taxation, I have given you insights on how you can be of mutual assistance to each other within your organization and how you can reach out to others who are engaged in taxation outside Malaysia who may share your goals, interests and needs.

Thank you and Mabuhay.

SWISS BRANCH OF IFA

Overview of the activities in 1981

In 1981 the management of the Swiss Branch of IFA met three times. These meetings immediately preceded the general meetings of the members at which the subjects of discussion were current national and international developments. The management stresses the good relationship with the General Secretariat of IFA in Rotterdam (the Netherlands).

By the end of 1981 the Swiss Branch had 319 members (254 individual persons and 65 legal entities), i.e. 26 more than at the end of 1980. On 30 January 1980 Mr. Fritz Branderet (Head of the Legal Service of the Federal "Wehrsteuer" Division (income tax and net wealth tax)) of the Federal Revenue Service and Prof. Dr. Ernst Höhn, St. Gallen, read papers on "Income from capital and capital gains in income tax law". The discussion focussed on the practice of the Federal Court which considers tax-free capital gains as taxable income from capital. A number of delegates expressed their doubts whether this practice has a sound legal basis.[1] Another

1. F. Banderet: Vermögensertrag und Kapitalgewinn in 36 *Steuer Revue* No. 9 (1981) at 383; E. Höhn: "Die Abgrenzung von Vermögensertrag und Kapitalgewinn im Einkommensteuerrecht", in 50 *Archiv für Schweizerisches Abgaberecht* No. 10 (1982) at 529.

subject which was discussed was an initiative taken by the Parliament of the canton of Graubünden with respect to the computation of the income of electric power stations working in more than one canton. The motives of the initiative were explained by Dr. T. Russi, Head of the Legal Service of the Tax Administration of Graubünden. The standpoint of the electric power stations and distributors of electricity was clarified by Mr. C. Hertig, notary and director of the Bernsche Kraftwerke AG. The problems have certain tax aspects and will also affect the users of electricity. The discussion showed that the problems could not be solved through the application of the Constitutional provisions prohibiting double intercantonal taxation.[2]

At the general meeting of 19 June 1982, Dr. K. Locher, Director of the Federal Revenue Service, Dr. Maurice Aubert, banker , and Dr. Lionel Frei, Division Head of the Federal Police Department, read papers on "Exchange of information in taxation". It was shown that the restrictive policy followed up to now by the Federal authorities has substantially changed. These changes are mainly based on Art. 3(3) of the new Federal Law on international aid in criminal cases of 20 March 1981 which will take effect on 1 January 1983. This provision will enable foreign States to obtain assistance from the Swiss authorities in cases of tax fraud, provided that a number of conditions have been met.[3]

During the meeting of 13 November 1981, Mr. Ludwig and Dr. Constantin reported on the results of the 1981 IFA Congress held in Berlin. The national reporters for the 1982 IFA Congress in Montreal presented their report. Dr. Alphons Schmid (Basel) treated the subject: "The tax treatment of interest in international economic transactions". In this connection it is noted that Prof. Dr. E. Höhn will be the General Reporter on this subject. Mr. George Muller (Lausanne) discussed the subject: "Taxation of payments to non-residents for independent personal services". Mr. Cl. Brélaz, President of the Appeal Committee of the canton Vaud, gave an overview of the work accomplished in harmonizing Swiss taxation.

2. T. Russi: "Die Standesinitiative des Kantons Graubünden über die steuerliche Gewinnberichtigung bei Partnerwerken der Elektrizitätswirtswirtschaft" in 36 *Steuer Revue* No. 4 (1981) at 137; G. Hertig: "Die Standesinitiative des Kantons Graubünden über die steuerliche Gewinnberichtigung bei Partnerwerken der Elektrizitätsschaft" in 36 *Steuer Revue* No.4 (1981) at 146.

3. K. Locher: "Internationale Zusammenarbeit in Fiskalsachen in Schweizerischer Sicht, insbesondere die internationale Amts- und Rechtshilfe in Steuerstrafsachen" in 50 *Archiv für Schweizerisches Abgaberecht* No. 3 (1981) at 97; M. Aubert: "L'échange d'informations fiscales dans le traité d'entraide judiciaire enb matière pénale entre la Suisse et les Etats-Unis in 50 *Archiv für Schweizerisches Abgaberecht* No. 7 (1982) at 347. See also F. Zuppinger: "Probleme der internationalen Amts- und Rechtshilfe in Steuer-, insbesondere in Fiskalstrafsachen 50 *Archiv für Schweizerisches Abgaberecht* Nos. 1-2 (1981) at 5.

OECD ACTIVITIES IN THE FIELD OF TAXATION

(January–June 1982)

During this period a number of important projects relating to tax policy issues and international cooperation have been completed. These are mentioned in the following paragraphs. In addition, the OECD Committee on Fiscal Affairs has continued to provide a forum where tax authorities of the OECD Member countries can meet regularly and exchange views on the current tax policy issues.

INTERNATIONAL COOPERATION

New OECD Model Double Taxation Convention on Estates and Inheritances and on Gifts

On 3 June 1982, on the proposal of the Committee on Fiscal Affairs, the OECD Council agreed to the derestriction of the new OECD Model Double Taxation Convention on Estates and Inheritances and on Gifts and recommended to Governments of OECD Member countries that they conform to the model when concluding new conventions or revising existing ones (see text in Annex below). This text will be published shortly.

Draft Multilateral Administrative Assistance Convention in Tax Matters

The Committee adopted on 7 July 1982 a draft Multilateral Administrative Assistance Convention in Tax Matters containing 35 Articles and the accompanying Commentaries which are for the use of the Council of Europe. It is expected that this draft will be forwarded to the Council of Europe in the Autumn when the OECD Council has approved its transmission. The draft will then be taken as a basis for the elaboration of an international convention.

Transfer Pricing, Corresponding Adjustments and the Mutual Agreement Procedure

A report on "Transfer Pricing, Corresponding Adjustments and the Mutual Agreement Procedure", which complements the 1979 OECD report on transfer pricing has been completed. The report assesses the legal and practical considerations involved in making use of provisions similar to those of Articles 9 and 25 of the 1977 OECD Model Convention and sets out the views of tax authorities of OECD Member countries on possible improvements in the mutual agreement procedure. The question is of considerable importance to private business. The text of the report will be available upon request as from the Autumn 1982 and is expected to be issued in printed form next year.

Specific activities

Other work related to international cooperation underway in the Working Parties deals with double taxation issues related to specific activities, such as leasing and improper use of tax conventions; on transfer pricing, the allocation of central costs, the tax treatment of foreign exchange gains and losses and transfer pricing in the banking sector are being examined. On tax evasion, key projects deal with the taxation of operations involving low-tax countries; consequences of bank secrecy for the administration of taxes and international cooperation; taxation of itinerant activities and hiring-out of labour and entertainment.

TAX ANALYSIS AND TAX STATISTICS

A new interpretative guide to the OECD Revenue Statistics series has been finalised and will be used for the 1983 data collection round. A report on tax collection lags will provide internationally comparable data on the lags between the collection of income taxes and the earning of the income which gave rise to the tax liability. It will be published next year but is already available on request. Reports on taxes on immovable property and on the macro-elasticity of the individual income tax will be finalized towards the end of 1982.

In July 1982, the Committee approved a new work programme for its Working Party No. 2 on Tax Analysis and Tax Statistics. The priority topics are: the interaction between inflation and the personal income tax systems; the use of tax expenditure budgets; quantitative illustration of corporate income systems; a review of the methods available to compare effective corporate tax burdens. The Group will continue to undertake international statistical comparisons on revenue statistics[1] and on the tax/benefit position of different income groups.[2]

Towards the middle of 1981, the Committee launched a new series entitled "OECD Studies in Taxation". It will be used to publish some of the more technical studies, mainly carried out by Working Party No. 2. The studies are, however, addressed to a wide audience and non-technical summaries are provided. To date, the following publications have been issued:

- The Impact of Consumption Taxes at Different Income Levels (June 1981);
- Income Tax Schedules: Distribution of Taxpayers and Revenues (November 1981);
- Long-term Trends in Tax Revenues of OECD Member Countries 1955-1980 (January 1982).

It is intended to publish in this series also the tax collection lags report and the macroelasticity report referred to above.

1. Last publication: Revenue Statistics of OECD Member Countries, 1965-1981, OECD, September 1982.
2. In October 1982 "The 1981 Tax/Benefit Position of a Typical Worker" will appear.

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releases 239 and 240
Commerce Clearing House, Inc., Chicago.

SIMON'S TAX CASES

releases 18-30
Butterworth & Co., London.

SIMON'S TAXES

releases 56-59
Butterworth & Co., London.

SIMON'S TAX INTELLIGENCE

releases 19-32
Butterworth & Co., London.

VALUE ADDED TAX – DE VOIL

releases 87 and 88

U.S.A.

FEDERAL TAXES – REPORT BULLETIN

releases 24-31
Prentice-Hall, Inc., Englewood Cliffs.

FEDERAL TAX GUIDE

releases 34-42
Prentice-Hall, Inc., Englewood Cliffs.

FEDERAL TAX GUIDE REPORTS

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FEDERAL TAX TREATIES – REPORT BULLETIN

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STATE TAX GUIDE

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TAX HAVENS OF THE WORLD

Walter Diamond
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Matthew Bender, New York.

TAX IDEAS – REPORT BULLETIN

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TAX TREATIES

releases 364-366
Commerce Clearing House, Inc., Chicago.

U.S. TAXATION OF INTERNATIONAL OPERATIONS

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ERRATUM

Article by Prof. Frans Vanistendael entitled: *Cutting Taxes on Business and Investment Income* in Bulletin for International Fiscal Documentation of July 1982.

On page 302, left column, fifth full paragraph, part of the first sentence was left out which completely changes the meaning of the text. This sentence should read: "Dividends distributed on the newly issued shares are exempt from corporate income tax up to 8% of the capital actually paid in."

The error is very much regretted.

INHALTSVERZEICHNIS

SOMMAIRE

Tax System Components and Economic Development: An International Perspective

By Sohrab Abizadeh* and J.B. Wyckoff**

Research in the area of public finance has traditionally focussed on the economic impact of taxes and government expenditure upon a region or a country. In recent years much of the applied and theoretical work has been related to the task of constructing tax systems suited to the particular economic and social conditions prevailing in a given year. In the most recent studies, however, the emphasis has been placed upon the relationship between tax ratio and the degree of economic development.

The following reports on an international study of the government direct and indirect tax revenues in different countries at different stages of economic development. The methodology consists of a number of short-run as well as long-run analyses. Pooled cross-section time series data are used. It is observed that, in the majority of cases studied, the structure of the tax system changes towards more intensive use of direct taxes as the nation's economy develops.

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INTRODUCTION

Developing countries have long been frustrated by the dilemma of developing a system of taxation which will provide the necessary resources to develop the infrastructure necessary for economic development, while providing incentives in the private sector for increased investment and output. Attempts to provide policy formulas through scientific studies of tax ratio differences and changes in tax components within given developing countries have taken different forms.

Martin and Lewis (1956) compared the revenues and expenditures of 16 countries at different levels of economic development. Their main objective was to see how patterns of expenditure and sources of revenue varied with economic development and what patterns of taxes and expenditure are appropriate to different levels of development.

Williamson (1961) in a follow-up of Martin and Lewis' study took more countries and a longer time period (1951-1956), including 17 developed countries with tax ratios (total tax revenue divided by gross domestic product) ranging between 20 and 35% and 15 LDCs ranging between 9 and 21%. Both of these studies concentrated on public expediture and revenue and their relationship to per capita national income.

Hinrichs (1965) questioned the former findings and tried to present a "better" explanation for the tax changes through a multiple regression study of 60 countries using data from the years 1957-60. He implicitly assumes that per capita income is the only factor needed to estimate the degree of economic development. Consequently, if there are other variables which explain tax ratio changes better than per capita national income, the conclusion that the tax ratio is related to the degree of economic development, as reflected by per capita income, should be rejected. He states:

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> Conventional wisdom holds that government revenue shares of gross national product increase with economic development. This is obvious when contrasting the level of government revenue shares between developed and less-developed countries. However, when observing differences among less-developed countries only, this proposition is misleading at the best or worst just plain wrong (p. 564).

Hinrichs (1966) in his more thorough study of taxes attempted to deal with both tax ratio and tax component changes during the course of economic development. He performs a multiple regression study of 60 countries for the period 1957-60 in order to identify the determinants of government revenue as a share of gross national product. Regional factors played an important role in his analysis of structural tax changes. The final outcome of past studies was the development and acceptance of the hypothesis that there exists a direct relationship between the degree of economic development and total tax ratio (see Abizadeh 1979). Despite all these efforts, analysis leading to policy recommendations on an improved combination of components within a tax system at differing stages of economic development has not been forthcoming.

RATIONALE

The position that, "Generally, however, tax systems have tended to be more of a determined than determining factor" (Hinrichs 1966, p. 63) is frequently found in writings on economic development. Bangs (1968) makes even a stronger assertion stating, "the tax changes are, in the main, effects rather than causes of economic progress" (p. 15). He further indicates that direct taxes are applicable only to those economies which have passed a certain stage of development (pp. 15-16). Hinrichs (1966) supports this, observing that the extent of reliance on direct taxation usually increases with greater economic development.

This would seem logical in examining the feasibility of direct tax collection in less developed countries compared with that of more developed countries. In general, corporate taxes are levied at a flat rate on all companies in less developed countries. The revenue yield generated by such a levy would be low because (a) company income is often only a small part of national income; (b) the tax rate must be low to encourage private investment; (c) developing companies do not have any revenue to be taxed; and (d) more importantly,

> . . . there takes place a substantial avoidance of the tax on corporate profits in underdeveloped countries because of the "loophole" in the law in the form of the system of prerequisites such as office-provided cars, living accommodation, travel expense accounts in general which are charged off to business expenses (Thripathy 1968, p. 201).

Direct taxation of capital values, whether land or personal property, would be expected to have a relatively less adverse effect upon incentives. The problem in underdeveloped countries has been that the owners of capital assets have had a high degree of control over political institutions, through which they could influence tax legislation in their favor. Goode (1964) points out that, "Intensive use of the property tax is blocked in most Latin American countries by a small but politically powerful group of large landowners" (p. 178). This is true in most underdeveloped countries - especially if land reform has not taken place. Inadequate records and appraisals of properties lead to comparatively low tax yields. "In many countries taxation of agriculture, particularly land tax, does not yield amounts considered adequate when compared with taxation of other sectors" (Basch 1964, p. 95). Unless there are some changes in the social, economic, and political institutions within underdeveloped countries, adoption of capital and wealth taxes - without wholesale evasion - would seem unlikely.

The use of personal income taxes has also generally been very limited in underdeveloped countries. In LDCs the agricultural sector is frequently exempted for constitutional or administrative reasons. Since agriculture is usually the main source of income for much of the population, the personal income tax plays a less significant role in the tax structure of LDCs than has been the case in the more developed countries.

Other reasons for the radically different performance of the personal income tax in underdeveloped as compared to developed countries include the following. First, there are the widely recognized problems in defining income. Second, there are difficulties in determining individuals' income, even after income is defined. In underdeveloped countries, a large sector of the economy is non-monetary or unrecorded. Wage-earners, independent craftsmen, and small shopkeepers cannot read and write well enough to maintain accounts or complete even the simplest income tax return. Sometimes, even literate income earners do not keep reliable records of their income. As in developed countries, more than one set of income records may be kept in order to avoid taxes (see Goode 1964). With unsophisticated banking and credit systems, it is difficult to trace cash and barter business transactions.

A third reason for the radically different performance of the personal income tax is related to the application of tax rates and allowances. It is difficult to fully apply the taxation rates of developed countries to less developed countries. This is because of the difference between the income distributions. If the tax rates found in the U.S. were applied to, say, Egypt or Iraq, the key to the revenue yield would depend upon whether they are applied at the same absolute level of income or at the same relative level of income.

The fourth difficulty relates to the collection of taxes. Voluntary tax payment is not common in underdeveloped countries. The alternative is a pay-as-you-earn system. Such a system would cover only a small percentage of income earners, i.e. those whose income, wages, and salaries can be identified and, therefore, raises the question of equity (i.e. only part of the country's income earners are subject to tax).

Thus, it is no accident that the more developed countries have usually progressed from indirect taxes such as customs duties, property taxes, and excise taxes during the early stages of their development, to the more sophisticated forms of direct taxation, such as personal and corporation income taxes (Bangs 1968, pp. 135-136).

HYPOTHESIS

On the basis of this previous work, a general hypothesis was formulated: as a nation's economy develops, the structure of the tax system changes toward intensive use of direct taxes, i.e. the relative proportion of direct and indirect taxes changes toward a higher and higher direct tax ratio.

This hypothesis was tested by a model containing variables representing and reflecting the degree of economic development as independent variables and the direct tax ratio (total direct tax revenue divided by total tax revenue) as the dependent variable. The general hypothesis was tested by the model for different time periods for the same group of countries and different groups of countries for the same time period.

The countries were selected with a view toward giving representation to a broad range of institutional conditions as well as stages of economic development. Countries from different regions of the world were selected, although the original analysis did not involve a regional factor.

GROUPING COUNTRIES BY FACTOR ANALYSIS

The task of selecting variables to indicate the degree of economic development was most difficult. The 1973 and 1976 studies by Irma Adelman and Cynthia Taft Morris were consulted. Based upon these studies a decision to employ quantitative information while avoiding qualitative measures seemed appropriate. Data were obtained from sources such as the United Nations and the International Monetary Fund.

Data were collected for a 23-year period (1950-1972). The period was divided into two sub-periods, a "first decade" (1950-1959) and a "second decade" (1960-1972). Forty-one countries were included in the analysis of the first decade and 46 in the second decade.

Although many researchers have classified countries according to their stage of development, none has developed a method universally acceptable to economists. Per capita income and its substitutes have been a widely used criteria (see Chelliah 1971, p. 277). Hinrichs (1966) groups countries on the basis of per capita GDP, the natural rate of population increase, and energy consumption per capita, with a relatively heavy reliance on per capita GDP. He states:

> Although GDP/N tends to be an unreliable estimate of the welfare of the consumers of a nation, and the statistics themselves are usually somewhat inaccurate, they are useful data for stage classification. . . Although GDP/N is a poor estimate of welfare, it is, in relative terms, a good measure of development (p. 130).

Because of the important role assigned to the grouping of countries in this study, a more comprehensive approach was employed. A multi-variate statistical technique, factor analysis, was used to perform this grouping function. Ten variables were selected for the factor analysis:
(1) per capita GDP in U.S. dollars;
(2) international trade tax ratio (defined as trade taxes divided by total tax revenue);
(3) percentage of total government expenditure on health (defined as total government expenditure on health divided by total government expenditure);
(4) percentage of total government expenditure on education;
(5) proportion of national income generated in agriculture, forestry, and fisheries;
(6) demand deposit ratio (defined as demand deposit divided by total money supply);
(7) export plus import divided by GDP in U.S. dollars;
(8) net balance on current account divided by GDP in U.S. dollars;
(9) exports divided by GDP in U.S. dollars; and
(10) imports divided by GDP in U.S. dollars.
Each of these variables was hypothesized to directly or indirectly represent the degree of economic development within a country.

The factor analysis identified 3 "factors" in each time period which accounted for virtually all of the variations (Tables 1 and 2). The grouping of countries was done for each decade with the same analysis being used to facilitate the possibility of interdecade as well as inter-country comparisons. Tables 3 and 4 show the respective country groupings for decade 1 and decade 2.

TABLE 1

Cumulative percentages of 4 factors for the first decade

Factor	*Eigenvalue*	*Percent of variation*	*Cumulative percentage*
1	17.195	42.2	42.2
2	13.137	32.3	74.5
3	7.887	19.4	93.9
4	2.482	6.1	100.0

TABLE 2

Cumulative percentages of 4 factors for the second decade

Factor	*Eigenvalue*	*Percent of variation*	*Cumulative percentage*
1	16.918	38.9	38.9
2	12.457	28.6	67.5
3	8.463	19.5	87.0
4	5.654	13.0	100.0

TABLE 3

Grouping of the countries by factor analysis, first decade

Group I	*Group II*	*Group III*
1. Egypt	1. Brazil	1. South Africa
2. Ghana	2. Colombia	2. Canada
3. Costa Rica	3. Ecuador	3. United States
4. El Salvador	4. Israel	4. Venezuela
5. Guatemala	5. Japan	5. Austria
6. Chile	6. Jordan	6. Denmark
7. Peru	7. Lebanon	7. France
8. Burma	8. Turkey	8. Netherlands
9. Ceylon	9. Finland	9. Norway
10. India	10. Ireland	10. Sweden
11. Iraq	11. Italy	11. Switzerland
12. Philippines	12. Spain	12. United Kingdom
13. Syria		13. Australia
14. Thailand		14. New Zealand
15. Portugal		

TABLE 4

Grouping of the countries by factor analysis, second decade

Group I	*Group II*	*Group III*
1. Egypt	1. Ghana	1. South Africa
2. El Salvador	2. Kenya	2. Canada
3. Peru	3. Tanzania	3. United States
4. Burma	4. Costa Rica	4. Brazil
5. Ceylon	5. Dominican Rep.	5. Colombia
6. Iraq	6. Guatemala	6. Venezuela
7. Malaysia	7. Chile	7. Japan
8. Syria	8. Ecuador	8. Austria
9. Thailand	9. India	9. Denmark
	10. Iran	10. Finland
	11. Israel	11. France
	12. Jordan	12. Italy
	13. Lebanon	13. Netherlands
	14. Philippines	14. Norway
	15. Turkey	15. Spain
	16. Ireland	16. Sweden
	17. Portugal	17. Switzerland
		18. United Kingdom
		19. Australia
		20. New Zealand

THE MODEL

The relative importance of tax components (groups of taxes) may be analyzed either as their percentage in total tax revenue or as their ratio to GNP. Chelliah believes that the first alternative more clearly defines the differences in the patterns of taxation between different countries, irrespective of the level of taxation (1971, pp. 267-368).

In this study, the tax components were analyzed in terms of the percentage of direct taxes in total tax revenue. It was hypothesized that, as an economy develops, the tax structure of the country changes toward more intensive use of direct taxes, i.e. the relative proportion of direct taxes in total tax revenue tends to increase. It was decided to test the hypothesis using long-run data to insure that sufficient time for a transition, in terms of economic development, was involved.

The following relationship was postulated to test the hypothesis:

$$TR^d_{it} = b_1 + b_2 (Y^p_{it,2}) + b_3 (OP_{it,3}) + b_4 (TPR_{it,4})$$
$$-b_5 (ER_{it,5}) - b_6 (AR_{it,6}) + b_7 (DDR_{it,7})$$

where

$i =$ 1,2, . . ., N(number of countries in the particular group in the model)
$t =$ 1,2, . . ., T (number of years, depending on the decade being analyzed)
$TR^d =$ direct tax ratio (defined as total direct tax revenue divided by total tax revenue)
$Y^p =$ per capita GDP in U.S. dollars converted using market exchange rates
$OP =$ openness (defined as exports plus imports divided by GDP)
$TPR =$ transfer payment ratio (defined as government transfers divided by government expenditures)
$ER =$ ratio of expenditure on education
$AR =$ proportion of income generated in agriculture, forestry, and fisheries
$DDR =$ demand deposit ratio (defined as demand deposit divided by total money supply).

Openness was specifically included because of its relationship to direct taxes emphasized by Hinrichs who states:

> . . . personal income taxes may be based primarily on civil servants . . ., the army . . ., and/or employees of large mineral and/or export companies, especially foreign ones. Thus, the openness of the economy would normally affect the amount of personal income collected (1965, p. 556).

If this relationship was maintained, openness should have carried a positive sign in the models.

Multiple linear regression analysis was applied to test the relationships hypothesized in the model. The results obtained for different groups of countries at different points in time were tested using the Durbin-Watson Statistic. The test indicated that it was not possible to reject the hypothesis that auto-regression was present. The Durbin procedure then was used to correct for the possible autoregression. Table 5 summarizes the results obtained from the corrected multiple linear regression models.

The first regression equation reported in Table 5 shows results for 41 countries for the 10-year period using pooled cross-section, time series data. Regression 2 used the identical model for 46 countries for the 13-year period. The remainder of the regressions reported were estimated to determine if the specified relationships hold for the different groups of countries during the first and/ or second decade.

TABLE 5

Summary of regression analyses for direct tax ratio (TR^d), original model[1)]

	Constant	Y^p	*OP*	*TPR*	*ER*	*AR*	*DDR*	R^2	*F Value*	*Durbin-Watson St.*
First decade, all countries	.0402 (.008)	.0000611^{+} (.0000353)	–.0455 (.0604)	–.109^{+} (.0656)	–.109 (.184)	.008 (.131)	–.0134 (.109)	.028$^{\times}$	1.22$^{\times}$	2.00^{b}
Second decade, all countries	.00883 (.00199)	.0000144$^{\times}$ (.0000105)	–.01741 (.0480)	–.0348 (.0702)	.078 (.0857)	.048 (.0668)	.116* (.0487)	.020$^{\times}$	1.63$^{\times}$	1.84^{b}
First group, both decades	.0416 (.00905)	–.0002741° (.00013)	.0478 (.0821)	–.130$^{\times}$ (.095)	–.141 (.182)	.223° (.102)	.0219 (.0976)	.076°	2.13$^{\times}$	1.56^{c}
First group, first decade	.429 (.0186)	–.000149 (.000178)	.151 (.133)	–.208$^{\times}$ (.128)	–.225 (.268)	.145 (.173)	.0757 (.197)	.097$^{\times}$	1.29$^{\times}$	1.78^{b}
First group, second decade	.0529 (.0172)	–.000057 (.000261)	.0117 (.099)	.174 (.199)	.011 (.268)	.177$^{\times}$ (.129)	–.146$^{\times}$ (.111)	.077$^{\times}$	1.07$^{\times}$	1.24^{a}
Second group, both decades	.0106 (.00267)	.0000538^{+} (.0000297)	–.0119 (.0446)	–.0491 (.0586)	.165^{+} (.0952)	–.187° (.0882)	.0542 (.058)	.049°	2.11°	1.82^{b}
Second group, first decade	.0352 (.0068)	–.0000437 (.000047)	–.135* (.0577)	–.0091 (.066)	.44^{+} (.243)	–.115 (.203)	–.143 (.118)	.140^{+}	1.99^{+}	1.62^{b}
Second group, second decade	.0085 (.0034)	.0000922* (.0000369)	.0663 (.066)	–.101 (.102)	.133 (.108)	–.154$^{\times}$ (.0995)	.110$^{\times}$ (.069)	0.84**	2.50**	1.99^{b}
Third group, both decades	.0912 (.0048)	(.0000367) (.0000129)	–.222** (.0675)	–.053 (.0762)	–.0407 (.183)	–.107 (.243)	.26° (.116)	.05*	2.73*	2.22^{b}
Third group, first decade	.0807 (.0227)	.0000277 (.0000606)	–.204^{+} (.115)	–.0543 (.143)	–.437 (.483)	–.266 (.498)	.0442 (.222)	.067	1.11	2.14^{b}
Third group, second decade	.011 (.004)	.00000409 (.0000109)	–.221* (.0911)	–.0148 (.0938)	.080 (.162)	–.0484 (.246)	.356** (.104)	.069*	2.64*	2.07^{b}

1) Corrected for auto-regression by Durbin Procedure.
** Significant at the 99% level
* Significant at the 97.5% level
° Significant at the 95% level
+ Significant at the 90% level
× Significant at the 80% level
a Do not reject the hypothesis that the auto-regression is present at the 99% confidence level.
b Reject the hypothesis that auto-regression is present at the 99% level.
c The Durbin-Watson Statistic is inconclusive.
Figures in parentheses are standard error of the regression coefficients.

INTERPRETING THE RESULTS

The results obtained from analyzing the 41 countries' data for the 1950-59 period did not provide an unequivocal answer to the hypothesis tested. Y^p (per capita GDP) assumed a positive sign and was significant at the 90% level of confidence. However, TPR, the only other significant variable in the model, did not carry the expected sign. Although the coefficients were not significant, neither did OP, AR, or DDR carry the expected sign. It was concluded that due to the sharp differences in direction of direct taxes at different stages of development during the first decade, a regression including all of the countries was not able to provide a satisfactory explanation of the variation in the direct tax ratio associated with the degree of economic development.

The analysis of the data from the second decade for the 46 countries provided an improved explanation for direct tax ratio changes. It was concluded that, during the second decade, the more developed the country, the more direct taxes were collected relative to other sources of taxation. This held only when the total group of developed and developing countries and/or underdeveloped countries were combined.

Underdeveloped countries (Group I)

When the data for both decades were used for the group of underdeveloped countries (Group I), it was strongly maintained that TR^d had been decreasing during the period. Variables ER, OP, and DDR had the expected sign to support the general hypothesis even though they were not statistically significant. The regression equation relating to Group I countries in the first decade was less clear than that using both decades. Y^p carried a negative sign and was not significant. The same was true for AR, with a positive sign. Given the full model, it was concluded that TR^d dropped the first decade for the group of underdeveloped countries.

The results obtained from analyzing the data for underdeveloped countries during the second decade strongly indicate that TR^d had been decreasing for this group during the 1960-72 period. Per capita GDP (Y^p) carried a negative sign along with DDR. The latter was significant at the 80% level of confidence. OP and TPR, with positive signs, were not significant. Neither was ER with a positive sign.

Developing countries (Group II)

The results obtained from the regression analysis for Group II in both decades provided evidence that for the group of developing countries, the direct tax ratio is related to the degree of economic development. Y^p and AR and DDR carried the expected signs. Y^p was significant at the 90% level of confidence with AR being significant at the 95% level of confidence. ER carried a positive sign (contrary to our expectations) and was significant at the 90% level of confidence.

Analysis of the data for developing countries during the 1950-59 period revealed that the relative importance of direct taxes in total tax revenue decreased. Six of the 12 countries in the group relied on indirect sources of taxation more heavily during this period. These were the countries that shifted to the developed group (Group III) during the second decade. This is not contrary to the general result obtained from analyzing the developing countries during both decades since direct tax collection only became possible for this group of countries during the second decade.

Examination of the results for the group of developing countries for 1960-72 provided firm support for this position. Per capita GDP was significant at the 97.5% level of confidence and was positive. AR and DDR assumed expected signs and were significant at the 80% level of confidence. OP also carried the expected sign but was only significant at the 70% level of confidence.

Developed countries (Group III)

For the group of developed countries (Group III) TR^d did not increase as the economy developed. Analysis of the data from both decades for this group revealed that TR^d has been decreasing for the group of developed countries. Although Y^p carried a positive sign in this equation, it was not statistically significant. OP and TPR carried negative signs contrary to our hypothesis. ER and AR had negative signs but were not significant. DDR was significant at the 95% level of confidence but carried a positive sign contrary to our expectations.

When the data for the first decade were used, almost identical results emerged. While the F value was significant at approximately the 50% level of confidence, the model was not effective in explaining the direct tax ratio.

The analysis of the data for 1960-72 for the developed countries showed that direct taxes have been losing their relative importance in these countries. OP, TPR, ER and DDR carried signs contrary to those hypothesized. However, only OP and DDR were statistically significant.

THE "BEST" MODEL

Because the original model had many coefficients that were not statistically significant, a "best" model was analyzed which included only those variables significant at the 80% or higher levels of confidence (Table 6). The "best" model for the 41 countries for the period 1950-59 included only variables Y^p and TPR. Each of these variables was significant at the 90% confidence level with opposite signs. It again was concluded that the sharp differences in the direction of change in direct taxes at different stages of development during the first decade prevented the model from providing a satisfactory explanation of the variation in direct tax ratio associated with the degree of economic development.

For the second decade in the 46 countries, only per capita GDP and DDR remained in the "best" model with the expected sign. They were significant at the 80 and 97.5% level of confidence respectively. It was concluded that, for this decade, the more developed the country, the more direct taxes were collected relative to other sources of taxation.

Underdeveloped countries (Group I)

When data for both decades were used the "best" model included variables Y^p, TPR, and AR. Each of these variables were significant at the 97.5, 80, and 95% level of confidence respectively. The signs for these variables indicate that TR^d not only did not increase but decreased as the economy developed. This decrease was due to the reliance of countries on trade taxes. The decrease in TR^d did not result in a decrease in TR. What is shown was that the relative importance of direct taxes has been decreasing in these countries and the relative share of trade taxes in total tax revenue (and possibly other indirect taxes) has been increasing. Some of these countries were, in fact, using other indirect sources during the first decade and shifted to the second group in the second decade, a group where the stage of development permits direct tax collection to be practiced.

By way of comparison Chelliah analyzed the relationship between the share of direct taxes (TR^d) and per capita income for 50 countries for the period 1966-68. His results were as follows:

$$TR^d = \underset{(5.575)}{33.08} - \underset{(1.059)}{0.052}\ (Y^p)$$

with an $R^2 = 0.005$ for the countries with per capita income below U.S.$ 200 (the figures in parentheses are t-ratios) (1971, p. 314).

Had it been possible for these countries to collect direct taxes, they might have done so. Direct tax collection has been and still is practically impossible for countries at this stage of development. Invariably, attempts to shift

TABLE 6

Summary of regression analyses for direct tax ratio (TR^d), "best" model 1)

	Constant	Y^p	OP	TPR	ER	AR	DDR	R^2	F Value	Durbin-Watson St.
First decade, all countries	.037 (.00428)	.0000632* (.0000334)		−.109^{+} (.0648)				.024°	3.23°	1.98^{b}
Second decade, all countries	.00903 (.00189)	.0000146$^{\times}$ (.0000104)					.113* (.0483)	.016*	3.91*	1.83^{b}
First group, both decades	.0416 (.0063)	−.000281* (.000124)		−.124$^{\times}$ (.0939)		.222° (.100)		.071**	4.03**	1.57^{c}
First group, first decade	.429 (.0084)		.195^{+} (.121)	−.236° (.115)				.073^{+}	2.98^{+}	1.83^{b}
First group, second decade	.0526 (.0109)					.212^{+} (.120)	−.135$^{\times}$ (.100)	.063^{+}	2.71^{+}	1.22^{a}
Second group, both decades	.0111 (.00227)	.0000567° (.0000288)			.172^{+} (.0937)	−.192° (.0879)		.043*	3.73*	1.80^{b}
Second group, first decade	.0319 (.00597)		−.123° (.0545)		.483° (.235)		−.172$^{\times}$ (.113)	.127*	3.68*	1.59^{c}
Second group, second decade	.009 (.003)	.000087* (.000035)				−.159$^{\times}$ (.099)	.120^{+} (.068)	0.72*	3.74*	1.90^{b}
Third group, both decades	.0912 (.00402)		−.224** (.0666)				.264* (.116)	.047**	7.85**	2.21^{b}
Third group, first decade	.0869 (.00909)		−.222° (.108)		−.491 (.435)			.059^{+}	3.01^{+}	2.11^{b}
Third group, second decade	.0124 (.00312)		−.223* (.0889)				.357** (.103)	.067**	3.01^{+}	2.08^{b}

1) Corrected for auto-regression by Durbin Procedure.
** Significant at the 99% level
* Significant at the 97.5% level
° Significant at the 95% level
+ Significant at the 90% level
× Significant at the 80% level
a Do not reject the hypothesis that the auto-regression is present at the 99% confidence level.
b Reject the hypothesis that auto-regression is present at the 99% level.
c The Durbin-Watson Statistic is inconclusive.
Figures in parentheses are standard error of the regression coefficients.

to direct taxes meet with serious administrative, political, and social obstacles.

The "best" model for the underdeveloped countries for the first decade includes OP with a positive sign, significant at the 80% level of confidence, together with TPR with a negative sign significant at the 95% level of confidence. The negative per capita TPR reinforced our preceding conclusions. The positive sign for OP during this period supports Hinrich's assertion that underdeveloped countries may collect income taxes on import/export companies.

The "best" model for the underdeveloped countries for the second decade included AR, and DDR with a positive and negative sign respectively. AR was significant at the 90% level of confidence and DDR at the 80% level. The signs of the "best" model variables suggest an actual decrease in TR^d as the economy develops. This sustains the conclusion that the group of underdeveloped countries has been decreasing its reliance on direct taxes. That means that the relative importance of direct taxes decreased for the group of underdeveloped countries during this stage of development.

Developing countries (Group II)

Based upon the "best" model for the second group for both decades, it was concluded that the direct tax ratio had increased in connection with their economic progress. The positive signs for ER were the result of its appearance in the model during the first decade. In fact, based upon results obtained, it was not until recent years (1960-72) that the group of developing countries started increasing their reliance on direct taxes and, as a result, increased the relative importance of this type of tax in the government revenue system.

The "best" model for the developing countries for the periods 1960-72 introduced Y^p, AR, and DDR as the variables most closely associated with the direct tax ratio. They were significant at the 97.5, 80, and 90% level of confidence respectively. It was concluded that the hypothesis held strongly for the developing countries during the period. This indicates that developing countries can rely more and more on direct taxes as their economy develops. This supports our earlier conclusion that the reliance and employment of direct taxes becomes possible at this stage of economic development.

Developed countries (Group III)

The "best" model for the Group III developed countries included OP and DDR. It indicates that the relative importance of direct taxes has been decreasing in total tax revenue for developed countries.

The "best" model for the first decade for developed countries was not promising. The only variable which remained in the model was OP with a negative sign and significant at the 95% level of confidence. However, ER was also included and carried a negative sign significant at approximately 70% level of confidence.

The analysis of the second decade for the developing countries produced evidence that the development and use of taxes other than conventional direct taxes are responsible for this type of relationship between TR^d and the degree of economic development.

There is no doubt that the absolute amount of direct taxes collected in developed countries has been and is increasing. It is the variation in the collection of such taxes that results in such a "poor fit" for our models. Factors other than just the degree of development have affected direct tax collections in developed countries. In addition to those factors mentioned earlier, other factors affecting direct levies are the types of dominant business sector in the economy (partnership, proprietorship, or corporation), the type of government, and the size of public sector relative to the total economy. In the case of the latter, the larger the public sector the higher the amount of payroll taxes collected.

The results obtained from the analysis of data for developed countries invites the quotation of a statement by Chelliah.

> On an analogy with the course of evolution in the now developed countries, it is generally argued that with the growth of the economy and the rise in income the share of direct taxes, which could be levied more in accordance with the individual's ability to contribute, would begin to rise. Such a transformation of the tax system is yet to come (1971, p. 269).

CONCLUSIONS AND GENERALIZATIONS

The general hypothesis of this study was not rejected in total, but a wide range of exceptions were observed. The analytical results have led us to the following conclusions and generalizations.

1. Due to the sharp differences in the tax components of countries at different stages of development, the general study of all of the countries during the first decade did not provide a satisfactory explanation for the variations in direct tax ratio an its relation to the degree of economic development.
2. Use of the data in recent years (1960-72) for all the countries did support the hypothesis.
3. There is no hard evidence, based on the result obtained, that the group of underdeveloped countries has increased its relative reliance on direct taxes as their economy developed. However, based on the maintained hypothesis that the total tax ratio has been increasing, it was concluded that tax components have shifted towards a more intensive use of taxes other than direct taxes.

   The direct tax ratio decreased during the last two decades for this group of countries. It was concluded that the imposition and collection of direct taxes are practically impossible and encounter numerous administrative as well as political and social obstacles.
4. The group of developing countries in both decades did rely more and more on direct taxes as their economies developed. However, it was not until the second decade that these countries could experience a systematic increase in their direct tax ratio along with their economic progress.

   The results from the regression for the second decade support the above assertion. It is concluded that direct tax collection, and the increase in its relative importance compared to other types of taxes, becomes possible when a country is in its "developing" stage. However, reliance on indirect taxes remains desirable to increase tax revenue because a lag exists between the time that a country enters this stage of development and the time it can actually rely more heavily on direct taxes.
5. Direct taxes have been losing their relative importance in the budgets of the governments in developed countries.
6. The term "better tax system", which has always been associated with a higher relative reliance on direct taxes, is somewhat misleading. A "better tax system" with respect to an economic development objective would be the one that results in higher taxes as a proportion of GDP, implicitly assuming no disincentive in the private sector, and investment yields in the public sector at least equal to private investment. Consequently, it makes little difference from this perspective as to what type of tax sources, direct or indirect, are being used more intensively.

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Zambia's 1982 Budget

by A.B.C. Emmanuel *

The Budget, as expected, was a belt-tightening one.[1] The worsening world economic conditions had and were having their adverse effects on the economy of Zambia, mainly because the demand for copper, which is the prime foreign exchange and revenue earner for Zambia, was dropping steadily. In addition, the copper consuming countries tended to hold smaller stocks of copper in order to reduce the costs of stock-holding. The average price of copper, which was 1,692 K per tonne in 1980, dropped to 1,554 K in 1981 representing a decline of 8.2%. Copper earnings declined from 884,000,000 K to 840,000,000 K, decline of 5%. The foreign exchange earnings from the mining sector fell from 1,200,000,000 K to 942,600,000 K. At the time, the demand for cobalt, the other revenue and foreign exchange earner, also fell badly leaving the mining companies a stock pile of about 8 months' production.

The mining industry, which is the mainstay of the country's economy, was thus afflicted by serious problems with the result that the industry's value added declined by 52.3% and the contribution of the mining sector to Gross Domestic Product declined from 16.2% in 1980 to 7.6% in 1981. In 1980, the mining companies contributed approximately 41.0 million K to Government revenue whereas in 1981 their contribution was virtually nil.

The manufacturing industry's contribution also fell during this year, mainly due to the lack of foreign exchange which had severe repercussions on those industries which are dependent on imported inputs. These difficulties were further increased by labour unrest and other factors which caused production to fall. The worsening financial position of the mining companies had their adverse effects on some of the manufacturing companies who relied a lot on the mines for their progress and prosperity. The industries depending on foreign inputs registered a drop ranging from 27% to 12%. Those who depended on local raw material did show a slight growth in the rate of production.

Against this gloomy background, there was, however, one ray of sunshine, which was in the agricultural sector. The performance in the agricultural sector was quite heartening and encouraging. The agricultural sector responded well to the call of His Excellency the President to boost the production of food in the country. This sector recorded an estimated growth rate of 9.8% in 1981. There was a significant increase in marketed maize of 3.5 million bags over the 1980 production, bringing in a total production of 7.7 million bags. In other fields of agricultural production, such as wheat, sunflowers, soya beans, etc., there were significant increases. There was thus a positive response by the farming community to the Government's agricultural policy which gave them various incentives.

One of the greatest problems facing the Government was the deteriorating balance of payments position. This position has been brought about by declining foreign earnings and worsened by the rising costs of imports, especially oil. The external payment arrears stood at 420,000,000 K. Exports amounted to 961,600,000 K in 1981 as compared to 1,027,000,000 K in 1980, a reduction of 6.4%.

In spite of the strict import controls, imports increased from 884,500,000 K in 1980 to 907,200,000 K in 1981. As a result of the critical shortage of foreign exchange, the rate of growth has been hindered, and it has provided exteremely difficult to build up foreign reserves and reduce the payment arrears.

* Tax Manager, Price Waterhouse & Co., Lusaka. See for an extract of the Budget Speech, 36 *Bulletin for International Fiscal Documentation* 3 (1982) at 130.

1. The Budget proposals were enacted in the Income Tax Amendment Act No. 12 of 1982.

"In the light of this grim scenario and bleak outlook, the immediate and vital lesson for the nation is clear", said the Hon. Minister of Finance as he presented the Budget. "The nation must brace itself for more sacrifices and hard work." The economy of the country had to be restructured so as to reallocate the scarce resources away from consumption toward production. Consumption had to be curbed by means of strict controls, which in turn would curb inflationary tendencies. It was essential to bring about a reduction in subsidies which were a heavy drain on the nation's financial resources. It was also essential to promote industrial production based on domestic resources and also expand agricultural and food production.

Keeping all this in mind, the Hon. Minister of Finance's main idea in his Budget proposals was to raise the additional revenue required through indirect taxation. The burden of direct taxation was fairly heavy on the few who paid taxes and hence by means of indirect taxes as a whole society would bear their share of the sacrifice which was necessary to enable the nation to recover from the crisis in which it finds itself.

Excise duties were raised on cigarettes, tobacco, liquor and petroleum products. Customs duties were also raised on various items.

As far as income tax on individuals was concerned, considering the high incidence of income tax in Zambia and the rising cost of living, the Hon. Ministry of Finance did not raise income tax but instead gave concessions in the form of increased personal allowances. He also gave a welcome relief to married women who had been making representations to the Government to reduce the tax burden borne by them. Under the system prevailing at the time, it was the husband who got the benefit of the married allowance of 1,700 K. Hereafter, he announced, the husband and wife could by election 6 months before the commencement of the charge year ask for the married allowance to be apportioned between them, specifying the amount in which the married allowance is to be divided.

Regarding tax on companies, the Budget introduced a new system of paying corporation income tax. According to the prevailing practice, companies paid provisional tax in two instalments, on 14 August and 14 December following the end of the tax year. Hereafter, under the new proposals in the Budget, all business will now have to estimate in advance what their taxable income will be for the current year and pay provisional income tax on that estimated amount in four instalments before the end of the tax year. In short, this means the payment of the 1981/82 and 1982/83 taxes before the end of March 1983.

This proposal that two years' income tax will have to be paid in one year raised objections from the entire business community, who pleaded that the business enterprises lacked the cash resources to pay two year's taxes in one year. Many of them, in view of the current foreign exchange shortages, did not get their full allocations of import quotas and were finding it difficult to run their businesses profitably. This new system, they said, would have grave consequences on the viability of many businesses and also seriously retard investment and expansion in the economy as a whole.

The Hon. Minister, after considering all the representations made to him, did not, however, alter his original proposal, but to alleviate the tax burden on the business enterprises, he extended the time limit for the payment of the taxes over a period of 1½ years. He also gave the Commissioner of Taxes the power to extend the time limit in case of hardships and also the power to waive the penalties for late payments of tax, considering each case on its own merits.

The undistributed profits tax, which was introduced in 1979 and amended in the 1980 and 1981 Budgets due to severe and widespread criticism, was repealed this year and replaced by a new regulation which went back to the old system of "deemed" distribution of dividends. Where the Commissioner of Taxes considers that a company, in order to avoid or reduce tax, has not declared a dividend or declared a dividend inadequately, he will "deem" a dividend to have been declared and such deemed dividend will be taxable in the hands of the shareholder. The business community preferred this "deemed" distribution regulation to the undistributed profits tax which was regarded as a penal provision. The new regulation removes the indiscriminate penalty for non-distribution and identifies those companies who do not declare dividends or plough back their profits into the business.

The agricultural sector was given further incentives in order to boost the agricultural output of the country. The rate of tax on farming income, which was reduced to 25% in 1981, was further reduced to 15%.

Accelerated depreciation on farming machinery implements and equipment at 50% of the cost of the assets on a straight line basis was also granted.

There were proposals to grant incentives to the industrial sector: these were not implemented as such in the Amendment Act, but the Hon. Minister of Finance hopes to implement some of these when changes are made in the Industrial Development Act. An effort is being made to encourage rural development with a view to reversing the existing rural/urban disparity as well as the deteriorating terms of trade between primary producers in the rural areas and the urban consumers. The poor rural areas will not be allowed to subsidise the urban areas and the Government hopes to achieve this by a sustained implementation of appropriate pricing and credit policies.

The Budget is a remedial one with a view to correcting the economic ills of the nation. The call is for economic revival and self-reliance. the principal message in the Budget is the "restructure of the economy, deliberate diversion of resources from non-productive to productive uses, thereby promoting the resumption of self sustaining economic growth while achieving progressive improvements in the balance of payments". It is hoped that the nation will respond to this call by the Hon. Minister of Finance who is hopeful that the nation will.

Recent Changes in the Philippine Taxation of Individuals*

By Corazon P. Paredes**

INTRODUCTION

Beginning calendar year 1982, a new individual income tax system is in force in the Philippines. The so-called modified gross income tax scheme became part of the Philippine National Internal Revenue Code of 1977 (Tax Code) when Batas Pambansa Blg. 135[1] was finally approved by the President on 18 December 1981. The new system constitutes a significant departure from the old system whereby individuals, irrespective of their types of income, were generally taxed on a net income basis. The following are the important changes introduced by the new law: (a) categorization of income; (b) modified gross taxation of compensation income; and (c) retention of itemized deductions with respect to business income.

The modified gross income tax scheme was designed to eliminate administrative problems connected with the old system. Accordingly, certain specific objectives were identified with the adoption of the new system. These are: (a) simplification of income tax administration; (b) minimization of discretion in the determination and allowance of deductions by the taxpayer and tax examiner; and (c) rationalization of the income tax treatment of different types of income.

The manner of taxation of gains derived by individuals, whether citizen or alien, as well as corporations, domestic or foreign, from the sale of shares of stock classified as capital assets have likewise been modified by Batas Pambansa Blg. 221 which was approved on 25 March 1982.

The following is a summary of the recent changes in the Philippine taxation of individuals.

Contents

I. NEW MODIFIED GROSS INCOME TAX SYSTEM

A. Categories of income

1. Under the new system

Individual incomes are currently divided into three principal categories, namely, compensation income, business income, and passive income. Classification is based on the nature of the income derived and all three categories are meant to cover the entire range of individual incomes.

a. Compensation income

Briefly, compensation income covers all income arising from an employer-employee relationship, whether monetary or non-monetary. However, the Tax Code itself provides for a specific definition of the term "gross compensation income", which includes all income payments received as a result of an employer-employee relationship, such as salaries, wages, honoraria, bonuses, pensions, allowances for transportation, representation, entertainment, fees (including directors' fees) and other income of a similar nature, including compensation paid in kind.

The share of a partner from a general professional partnership for services is not considered as part of gross compensation income but as a partner's distributive share of ordinary business income.

* As of 31 July 1982.

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1. Batas Pambansa may be loosely translated as "Parliamentary Act" in Pilipino while "Bilang/Blg." means "number".

b. Business income

Business income refers to income derived from engaging in a trade, business or profession as well as all other income derived from any source whatsoever not classified as compensation income or passive income. The Tax Code specifically uses the term "gross income" for this category of income which broadly includes gains, profits and income derived from professions, vocations, trades, businesses, commerce, sales, or from dealings in property, whether real or personal, or growing out of the ownership or use of property or any interest therein; and from interest, rents, dividends, securities, or the transactions of any business carried on for gain or profit, or gains, profits and income of whatever kind and in whatever from derived form any source.

c. Passive income

Passive income includes interest, dividends, royalties, prizes and other winnings which are subject to a final withholding tax.

2. Under the old system

Under the old global income tax system, there was only one general category of income. Thus, as defined, the term "gross income" included gains, profits and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, sales, or dealings in property, whether real or personal, derived from the ownership of or use of or interest in such property; also from interest, rents, dividends, securities, or the transactions of any business carried on for gain or profit, or gains, profits, and income derived from any source whatsoever. In effect, all items of income were lumped together.

As under present law, certain types of passive income like dividends and interest were also subjected to a final withholding tax. Other types of passive income, like royalties and prizes, were merely subjected to a creditable withholding tax. In other words, these types of income were consolidated with the other income of an individual and the tax thereon was computed accordingly. Any withholding tax paid could then be credited against the income tax as finally computed. Nevertheless, these special types of passive income were not recognized as falling under a separate category of income.

B. Exclusions from gross income

The following items are currently treated as exclusions from gross compensation income:

1. Actual, moral, exemplary, and nominal damages received pursuant to a final judgment or compromise agreement arising out of an employer-employee relationship.
2. Proceeds of life insurance policies paid upon the death of the insured.
3. Amounts received by the insured as return of premiums paid by him under life insurance, endowment or annuity contracts.
4. Value of property acquired by gift, bequest, devise, or descent.
5. Interest on government securities.
6. Amounts received through accident or health insurance or under the Labor Code of the Philippines, as compensation for personal injuries or sickness plus the amount of any damages received on account of such injuries or sickness.
7. Income exempt under treaty.
8. Retirement benefits, pensions, gratuities received under certain conditions.
9. Other miscellaneous items such as income received from investments in the Philippines or interest on deposits in Philippine banks by (a) foreign governments, (b) financing institutions owned, controlled, or enjoying refinancing from foreign governments, and (c) international or regional financing institutions established by governments.

The same items of exclusion above enumerated are also excludable under the category of business income. In addition, compensation income as well as passive income which have already been subjected to a final tax are also entitled to be excluded from the coverage of business income.

Under the old system, the same excludable items were recognized for determining gross income.

C. Allowance for deductions

Another highly significant change introduced by the modified gross income tax system is the restriction on deductions. Under current law, no other deduction is recognized for the purpose of arriving at one's taxable compensation income except for the so-called personal and additional exemptions. The usual deductions previously allowed to a taxpayer for computing his net taxable income are presently still allowed but only for the purpose of computing one's taxable *business* income. Aside from limiting the itemized deductions to the category of business income, such items must also be business-related in order to be deductible.

1. Under the new system

a. Personal and additional exemptions

Whether an individual is deriving purely compensation income or business income or both under current law, he is still entitled to the personal and additional exemptions. The rates of personal exemption that may be availed of by such individual depends upon his status as single or married person or head of a family. A single individual or a married person judicially declared as legally separated is entitled to claim a personal exemption equivalent to ₱ 3,000. A married person may deduct ₱ 6,000 while an individual who qualifies as head of a family is allowed ₱ 4,500 as personal exemption. Head of the family means an unmarried person with one or both parents, or with one or more brothers or sisters, or with one or more legitimate, recognized natural or adopted children living with and dependent upon him or her for their chief support where such brothers, sisters, or children are not more than 21 years of age, unmarried, and not gainfully employed, or where such children are incapable of self-support because of mental or physical defect.

Additional exemptions equivalent to ₱ 2,000 may be further claimed by the taxpayer for each legitimate, recognized natural or adopted child wholly dependent upon and living with the taxpayer if such dependents are not more than 21 years of age, unmarried, and not gainfully employed or if they are incapable of self-support because of mental or physical defect. However, the Tax Code limits the number of dependents for which additional exemptions may be claimed. Such number must not exceed 4 dependents so that the maximum additional exemption is ₱ 8,000.

In view of the categorization of incomes, an individual who receives both compensation and business income is required to deduct first the amount of his personal and additional exemptions from his gross compensation. If there is any excess exemption, the same could then be deducted from his business income.

b. Itemized deductions

The availability of itemized deductions is presently restricted to the category of business income. Thus, for the purpose of arriving at net taxable income of taxpayers deriving business income, the following items may still be deducted:

1. Ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.
   Entertainment, travel, and representation expenses associated with the taxpayer's trade, profession or business may be allowed as deduction subject to certain substantiation requirements.
2. Interest paid or accrued on indebtedness incurred within a taxable year in connection with the taxpayer's profession, trade or business.
3. Taxes paid or accrued within the taxable year in connection with the taxpayer's profession, trade or business, except: (a) income tax, (b) income, war profits, and excess profits taxes imposed by a foreign government (this deduction will be allowed for a taxpayer who does not wish to avail himself of the foreign tax credit provision); (c) estate and gift taxes; (d) taxes assessed against local benefits of a kind tending to increase the value of property assessed; and (e) electric energy consumption tax.
4. Losses actually sustained during the taxable year, not compensated for by insurance or otherwise and incurred in the exercise of the trade, profession or business or incurred in a transaction entered into for profit though not connected with the trade or business.
5. Bad debts which are actually ascertained to be worthless and charged off within the taxable year in connection with the exercise of the profession, trade or business.
6. Depreciation of property arising out of its use in the profession, business or trade, or out of its not being used.
7. Depletion of oil and gas wells and mines.
8. Charitable and other contributions actually paid or made within the taxable year to certain institutions which may be deductible in full or limited to an amount not in excess of 6% of the taxpayer's net income as computed before the deduction for charitable contributions, depending on the classification of the donee-institution.
9. Payments for pension trusts.

Medical care expenses and basic tuition fees which were deductible under the old system (subject to certain limits and conditions) are no longer deductible items.

c. Optional standard deduction

Except for non-resident alien taxpayers, an individual reporting business income may elect a standard deduction not exceding 10% of his gross income, instead of availing himself of the itemized deductions. His intention to elect the optional standard deduction must be signified in the income tax return.

2. Under the old system

At the time the modified gross income tax scheme was introduced, the same rates of personal and additional exemptions were allowed under the old law for individual taxpayers depending also upon their status. Therefore, no change has been introduced in this regard.

Since there was only one category of income under the global approach, itemized deductions were generaly allowed unless the taxpayer elected the standard deduction. Generally, the same items of deductions were available in case the taxpayer chose itemized deductions for reporting his income. However, certain items were not required to be business-related in order to qualify as deductions. Thus, interest, taxes and bad debts, though not connected with trade or business, were nevertheless deductible in arriving at net taxable income under the old system.

Previously, any individual taxpayer other than a nonresident alien could also elect to take the standard deduction, not exceeding 10% of his gross income, in lieu of the itemized deductions. As under current law, unless the taxpayer signified his intention to use the optional standard deduction in his return, he was considered to have availed himself of the itemized deductions.

If the gross income reported by the taxpayer in his return included that of his wife, a standard deduction of 10% of the gross income received by his wife, but not to exceed ₱ 500, was allowed as an additional deduction regardless of whether such taxpayer used the itemized deductions or the optional standard deduction. This standard deduction for working wife has been deleted under the current system.

D. Tax rates

1. Under the new system

a. Compensation income

The following tax rates are in effect under the modified gross income tax system.

The taxable compensation income (gross compensation income less only personal and additional exemptions) received by a citizen or resident alien from world-wide sources is subject to the following rates:

Pesos	*Pesos + percentage of excess over lower amount*
Not over 2;500	0%
2,500 – 5,00	0 + 1%
5,000 – 10,000	25 + 3%
10,000 – 20,000	175 + 7%
20,000 – 40,000	875 + 11%
40,000 – 60,000	3,075 + 15%
60,000 – 100,000	6,075 + 19%
100,000 – 250,000	13,675 + 24%
250,000 – 500,000	49,675 + 29%
Over 500,000	122,175 + 35%

The tax rates imposed on compensation income are much lower as compared to the hold rates of 3% to 70% in force under the net income tax system. Previously, the 36% tax bracket was reached when one's net income exceeded ₱ 32,000. As a general rule, therefore, fixed income earners are favored under the gross income tax scheme because of the 50% reduction in the maximum tax rates and the increase in the taxable income base.

b. Business income

As a result of the categorization of incomes, the taxable net business income of a citizen or resident alien from world-wide sources is presently subject to a separate schedule of tax rates ranging from 5% on the first ₱ 10,000 to 60% on the excess over ₱ 500,000. The complete schedule of such tax rates is as follows:

Pesos	*Pesos + percentage on excess over lower amount*
Not over 10,000	5%
10,000 – 30,000	500 + 15%
30,000 – 150,000	3,500 + 30%
150,000 – 500,000	39,500 + 45%
Over 500,000	197,000 + 60%

There is only a slight reduction of the old maximum tax rate of 70% to 60% which is currently imposed under the new system, but the taxable income base has been increased.

c. Passive income

Passive income, consisting of dividends, interest, royalties, prizes and other winnings, is subject to the final withholding tax at varying rates. Dividends received by a citizen or resident alien from a domestic corporation and the share of an individual partner in a partnership which is treated as a corporation for tax purposes are subject to a 15% final withholding tax. Interest received by a citizen or resident alien on a savings deposit is subject to a 15% final withholding tax. Interest on time deposits and yields from deposit substitutes[2] and from trust funds and similar arrangements are subject to a 20% final withholding tax. However, if the aggregate amount of interest on a deposit account maintained by a depositor alone or with another in any one bank at any time during the taxable period does not exceed ₱ 1,000 a year or ₱ 250 per quarter, the same is exempt from tax. Royalties, prizes (except prizes amounting to ₱ 3,000 or less which should be taxed as business income) and other winnings received by a citizen or resident alien are subject to 15% final withholding tax.

2. Under the old system

Under the old system, only one schedule of tax rates was prescribed for items of income which came within the definition of the term "gross income". The rates ranged progressively from 3% on the first ₱ 2,000 of net taxable income to 70% on the excess over ₱ 500,000. However, dividends and interest from a savings deposit were subjected to the 15% final withholding tax. The same was true with respect to yields from deposit substitutes and interest from time deposits which likewise were subjected to the final withholding tax of 20%.

E. Classification of taxpayers

Individual taxpayers are generally divided into two classes, namely, citizens of the Philippines and aliens. Citizens of the Philippines can further be classified as residents or non-residents. Likewise, alien individuals may be classified as resident aliens or non-resident aliens. The same rules on classification of taxpayers recognized under the old law are currently being followed.

1. Citizens and aliens

Citizens and resident aliens are taxed on the basis of their world-wide income. The schedule of tax rates applicable will depend on the type of income earned by the taxpayer. However, in the case of non-resident citizens deriving income from sources outside the Philippines, a dollar schedule ranging from 1% to 3% based on the taxpayer's "adjusted gross income" is applied. Adjusted gross income means gross income from foreign sources less the total of personal exemptions allowed and the entire amount of foreign income tax paid by him.

Non-resident alien individuals are subject to tax only on the basis of their Philippine-source income. Non-resident aliens may further be classified into: (a) those engaged in trade or business in the Philippines; and (b) those not engaged in trade or business in the Philippines. A non-resident alien who comes to the Philippines and stays for an aggregate period of more than 180 days during any calendar year is deemed to be doing business in the Philippines. If his stay is 180 days or less, he is considered as not engaged in trade or business in the Philippines.

Non-resident aliens engaged in trade or business in the Philippines are generally subject to tax on their compensation and business incomes received from Philippine sources in the same way as resident citizens and resident aliens. However, dividends, shares in the net profits of a partnership (which is taxed like a corporation), interest,

2. As defined under the Tax Code, the term "deposit substitutes" means an alternative form of obtaining funds from the public, other than deposits, through the issuance, endorsement, or acceptance of debt instruments for the borrower's own account, for the purpose of relending or purchasing of receivables and other obligations. These include promissory notes, repurchase agreements, similar instruments with recourse authorized by the Central Bank of the Philippines for banks and non-bank financial intermediaries.

royalties, prizes and other winnings (except prizes of ₱ 3,000 or less which shall be taxed as business income) are subject to a 30% final withholding tax.

On the other hand, interest, dividends, rents, salaries, wages, premiums, annuities, compensation, remuneration, emoluments, or other fixed or determinable annual or periodical or casual gains, profits, and income from Philippine sources received by non-resident aliens not engaged in trade or business in the Philippines are subject to a final withholding tax of 30%.

However, capital gains realized by non-resident aliens, whether or not engaged in trade or business in the Philippines from the sale of Philippine shares listed in the dollar or any acceptable foreign currency on a stock exchange are currently exempt from income tax.

2. Residents and non-residents

The principles for determining whether or not an alien is a resident or non-resident remain the same whether under the old or new system.[3]

An alien individual's residency or non-residency status depends on the nature and length of his stay in the Philippines. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute one a transient. If he lives in the Philippines and has no definite intention as to his stay, he is a resident. One who comes to the Philippines for definite purpose which in its nature may be promptly accomplished is a transient. But if his purpose is of such nature that an extended stay is necessary for its accomplishment, and to that end he makes his home temporarily in the Philippines, 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 fulfilled or abandoned.[4]

F. Taxation of certain expatriates

As part of the incentives granted to certain businesses which help promote the Philippine economy, foreign employees hired by them are also entitled to preferential tax treatment vis-à-vis other expatriates.

Thus, alien individuals employed by regional or area headquarters established in the Philippines under Presidential Decree No. 218, offshore banking units established under Presidential Decree No. 1034 and service contractors or their subcontractors engaged in petroleum operations under Presidential Decree No. 87 are subject to a final tax of 15% based on their gross salaries including other emoluments.

G. Tax administration

1. Withholding system

The Philippine withholding tax system may be divided into four types, namely, withholding tax on wages, basic withholding tax at source, the "expanded withholding tax" and other special types of withholding. The growing use of the withholding tax as a mode of ensuring tax collection has been very apparent in recent tax laws. To further strengthen the system, a penalty is imposed upon the withholding agent if it fails to perform its obligations as such. Accordingly, any amount paid or payable by the withholding agent which is allowable as a deduction from gross income will be disallowed if it fails to deduct and withhold the tax in accordance with the law.

The withholding tax on wages is imposed on all forms of compensation arising from an employer-employee relationship, whether monetary or non-monetary. Specifically, the term "wages" is defined to include all remuneration for services performed by an employee for his employer unless specifically excepted under the law.[5] Thus, all amounts paid to an individual which fall within the category of compensation income will be subject to this type of withholding system.

Some relevant rules in this connection are: the basis upon which the remuneration is paid is immaterial in determining whether it constitutes wages. Thus, it may be paid on the basis of piecework, or a percentage of profits; and may be paid hourly, daily, weekly, monthly, or annually. Wages may also be paid in money or in some medium other than money, as, for example, stocks, bonds, or other forms of property. If services are paid for in a medium other than money, the fair market value of the thing taken in payment is the amount to be included as wages subject to withholding. Thus, as a general rule, pensions and retirement pay are considered wages subject to withholding. The same is true with respect to vacation allowances paid to an employee. However, amounts paid specifically - either as advances or reimbursements - for traveling or other bona fide ordinary and necessary expenses incurred or reasonably expected to be incurred in the business of the employer are not wages and are not subject to withholding. Traveling and other reimbursed expenses must be identified either by making a separate payment or by specifically indicating the separate amounts where both wages and expense allowances are combined in a single payment.

Ordinarily, facilities or privileges (such as entertainment, medical services, or "courtesy" discounts on purchases) furnished or offered by an employer to his employees generally are not also considered as wages subject to withholding if such facilities or privileges are of relatively small value or are offered or furnished by the employer merely as a means of promoting the health, goodwill, contentment, or efficiency of his employees.

The term "wages" includes remuneration for services performed by a citizen or resident of the Philippines, as employee of a non-resident alien individual, foreign partnership or foreign entity engaged in trade or business within the Philippines. Likewise, any person paying wages on behalf of a non-resident alien individual, foreign partnership, or foreign corporation not engaged in trade or business in the Philippines is constituted as the withholding agent.

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3. See Gison and Salvador, "Philippine Taxation of Alien Individuals", 35, *Bulletin for international fiscal documentation* 5, p. 223 (1981).
4. Income Tax Regulations, Section 5.
5. Revenue Regulations No. 20-81, "Withholding Tax for Compensation Income Under the Gross Income Tax System".

Compensation paid for services rendered in the Philippines irrespective of place of payment received by a non-resident alien not engaged in trade or business in the Philippines is subject to a final withholding tax of 30%. Every person who has the control, receipt, custody, disposal or payment of the income is constituted as the withholding agent.

2. Filing of returns and payment of tax

Citizens and resident aliens deriving purely compensation income must file their returns on or before 18 March of each year, covering income for the preceding taxable year. Individuals deriving business or professional income must file their returns on or before 15 April of each year. If the taxpayer derives both compensation and business incomes at the same time, the return covering both incomes must be filed on or before 15 April of each year.

II. REVISED TAXATION OF SALES OF SHARES OF STOCK

Gains of individuals, whether citizen or alien, or of corporations, domestic or foreign, from the sale of shares of stock classified as capital assets are currently subject to tax depending on whethert or not shares of stock are listed and traded on a local stock exchange. Previously, net capital gains from the sale, exchange, transfer or similar transactions intended to convey ownership of or title to any share of shares of stock were subjected to a final tax of 10%. However, if the shares of stock involved were that of a closed corporation, the tax rates were 10% on the first ₱ 50,000 of net capital gains and 20% on the excess.[6]

Under the present law, if the shares of stock sold or exchanged are listed and traded through the local exchange, a rate of 0.025% of the gross selling price is applicable. The stockbroker is constituted as withholding agent in this case.

On the other hand, if the shares of stock sold, exchanged or transferred are not traded through a local stock exchange, net capital gains derived therefrom are subject to a final tax of 10% on the first ₱ 100,000 and 20% on the excess. The seller must file the return and pay the tax on a per transaction basis, i.e. within 30 days following each sale or disposition of the shares of stock. An adjustment return is required to be filed after the close of the taxable year.

The net capital losses sustained during the taxable year are allowed as capital loss deductible in the same taxable year only. Moreover, the entire amount of capital gains and capital loss are considered without taking into account the period or duration during which the stocks were held by the seller up to disposition for purposes of computing net capital gains.

No sale, exchange, transfer or similar transaction intended to convey ownership of, or title to, any share of stock may be registered in the books of the corporation unless the receipt of payment of the tax is already filed with or recorded by the stock transfer agent or secretary of the corporation. The stock transfer agent or corporate secretary must also inform the Bureau of Internal Revenue in case of non-payment of the tax.

6. PD No. 1739.

Residency Concept and Employment Income in Nigeria

By A.C. Ezejelue*

INTRODUCTION

Although something may have been written generally on "residence" for tax purposes in Nigeria, this narrow aspect of the concept as it applies to employment[1] income requires fairly detailed and isolated treatment. The emphasis will be on foreign nationals who are deemed to be resident in Nigeria for tax purposes in respect of their employment income. The relevant Nigerian tax law on this is often not well understood or is misconstrued by non-resident taxpayers.

Therefore this short article is an attempt to construe the relevant tax law on the matter, for the guidance of foreigners whose employment incomes are deemed to be liable to Nigerian tax. Any interpretations offered here are by no means conclusive; they are open to challenges, even by the author himself, in the light of any new facts.

RELEVANT SECTIONS OF THE RELEVANT ACT

The relevant law for the subject under consideration is contained in Sections 4 and 8 of our Income Tax Management Act (ITMA) 1961 (as amended).

The pertinent provisions of Section 4 are as follows:

> *Section 4(1).* The tax shall, subject to the provisions of the Act be payable for each year of assessment upon income accruing in, derived from, brought into, or received in, Nigeria in respect of –
>
> . . .
>
> (b) any salary, wages, fees, allowances or other gains or profits from an employment including gratuities, compensations, bonuses, premiums, benefits or other perquisites allowed, given, granted by any person to an employee.

And the following subsections of Section 8 are apposite for our purposes:

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1. "Employment" includes any service rendered by any person in return for any gains or profits. See Sec. 4(2)(d) of Income Tax Management Act (ITMA) 1961 (as amended).

Section 8(1). The gains or profits from an employment shall be deemed to be derived from Nigeria if –

(a) the duties of the employment are wholly or partly performed in Nigeria, unless–

(i) the duties are performed on behalf of an employer who is in a country other than Nigeria; and

(ii) the employee is not in Nigeria for 183 days or more in a year of assessment; and

(iii) the remuneration of the employee is liable to tax in that other country.

(b) the employer is in Nigeria unless the duties of the employment are wholly performed, and the remuneration paid, in a country other than Nigeria save during any temporary visit to or leave in Nigeria.

. . .

(3) The gains or profits from any employment exercised in Nigeria shall be deemed to be derived from Nigeria whether the gains or profits from such employment are received in Nigeria or not.

A MATTER OF CONSTRUCTING RELEVANT LAW

It seems that the spirit behind Section 8 of ITMA on the concept of "residency" is to give the Revenue authorities a wide scope of collecting as much tax as possible under Section 4 of ITMA while at the same time making allowance for what may appear to be the minimum acceptable practice elsewhere.

Section 4(1)(b) is very wide, and does not give any exclusionery conditions when read in isolation. However, apart from being subject to other provisions of the Act, Section 4 must be read in conjunction with Section 8 which introduces some qualifying and ameliorating provisions. At the same time, all subsections of Section 8 should be read together partly for possible interpretative purposes and partly for resolving any appartent conflicts.

Section 4(1)(b) tends to rope in all kinds of income whether accruing in, derived from, brought into, or received in,[2] Nigeria if considered in isolation. But Section 8 stipulates the conditions under which an income shall be deemed to be derived from Nigeria. The emphasis is on "derived from" because derivation in this context implies "obtained" or "acquired" or "got" via working or having worked in or for Nigeria.[3] This is to be distinguished from "brought into" or "received in" or (to some extent) "accruing in", which may not necessarily imply worked or working in or for Nigeria.

The first general condition[4] is that an income from employment shall be deemed to be derived from Nigeria (and therefore subject to Nigerian tax) if the duties of the employment are wholly or partly performed in Nigeria. Thereafter, it introduces some counter-conditions under which the general condition shall not hold, i.e. if:

(i) the duties are performed on behalf of an employer who is in a country other than Nigeria; *and*

(ii) the employee is not in Nigeria for 183 days or more in a year of assessment; *and*

(iii) the remuneration of the employee is liable to tax in that other country.[5]

It must be emphasized that the above three counter-conditions must operate together in order to exclude the operation of the general condition under Section 8(1)(a).

Therefore, if, for example, (i) and (iii) above are true but (ii) is not true, the general condition will be expected to apply.

Section 8(3) emphasizes that once the principle of derivation from Nigeria is associated with any employment income in accordance with the provisions of subsection (1), that income shall be subject to Nigerian income tax, notwithstanding that the income may not have been received in Nigeria.

There is no conflict between subsections (1) and (3) of Section 8. Rather, they tend to complement each other. A taxpayer who is subject to Nigerian income tax under subsection (1), i.e. the "derivation principle", cannot claim that he is exempt simply because the income is not received in Nigeria. Similarly, a taxpayer who is subject to Nigerian income tax by virtue of subsection (3), i.e. "concept of received in", cannot claim that he is exempt simply because the income is not derived from Nigeria.

Again, subsection (3) of Section 8 does not overrule its preceding subsection (1)(a). It merely re-inforces it, and brings out the independence of the "concept of received in" from the "principle of derived from". Subsection 3 explains that income from *employment exercised in Nigeria* shall be deemed to be derived from Nigeria. This is a restatement of subsection (1)(a) which emphasizes that income from employment shall be deemed to be derived from Nigeria if the *duties of the employment are wholly or partly performed* in Nigeria. If an employment is exercised in Nigeria under subsection (3) it is similar to saying that the duties of that employment are performed in Nigeria (wholly or partly) under subsection (1)(a).

"Received in" and "derived from" are under two different categories. They are not mutually exclusive. An income which may not qualify for Nigerian income tax because it is not deemed to be derived from Nigeria may qualify for Nigerian tax on the ground that it is "brought into" or "received in" Nigeria. This is the implication of taking up Sections 4(1)(b) and 8(3) together.

GENERAL HYPOTHETICAL ILLUSTRATION

A general hypothetical example may prove useful to illustrate all the foregoing theories.

Assume that a Dutchman, Mr. A, resident in the Netherlands – thus a non-resident of Nigeria – is sent by his Dutch firm (employer) to work temporarily in Nigeria. A receives a salary for the work performed in Nigeria. Is A liable to Nigerian tax?

The position will be that if A stays in Nigeria for 183 days or more, his income, whether or not it is received in Nigeria, will be subject to Nigerian tax. But if he stays for less than 183 days (in the aggregate) there is no doubt

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2. For possible implications of the terms: "accruing in, derived from, brought into, or received in", see A.C. Ezejelue, "Taxation of Consultancy fees in Nigeria", 36 *Bulletin for International Fiscal Documentation* 8-9 (1982), pp. 421-424.
3. Id.
4. See Sec. 8(1)(a) ITMA.
5. Sec. 8(1)(a)(i-iii).

that his income will not attract Nigerian tax, provided also that the conditions under Section 8(1)(a)(i) and (iii) hold.

If we assume that A is not liable to Nigerian tax on the ground that his income is not deemed to be derived from Nigeria under Section 8(1)(a), what happens if A receives part of his salary in Nigeria to pay for living and other personal expenses? On the basis of the foregoing construction, this part of A's salary would have been received in Nigeria, and would therefore attract Nigerian income tax under Section 4(1)(b). An income may be liable to Nigerian tax simply because it is received in Nigeria notwithstanding that the income may not have been derived from Nigeria.

CONCLUSION

The issue of the determination of residence, generally, for tax purposes, in Nigeria is a very important one.[6] But it seems that the concept of residency as it affects employment income of non-residents is of greater importance because it tends to apply more to foreign nationals who are apt to misconstrue the position. Therefore, some efforts have been made in this article to highlight certain basic and vital issues. It is hoped that this will stimulate the interest of both academicians and practitioners.

6. For a detailed discussion of this, see A.C. Ezejelue, "Impact of residence on tax liability in Nigeria", 35 *Bulletin for International Fiscal Documentation* 12 (1981), pp. 547-554.

Conference Diary

DECEMBER 1982

Management Centre Europe: Taxation of International Group Companies and Branches (including: Taxation of branches and subsidiaries; taxation of shareholders; domestic and tax treaty "anti-avoidance" measures) (Seminar). Brussels (Belgium), December 2-3 (English).

Terzake Belastingen: Tax aspects of Doing International Business. Amsterdam (Netherlands), December 2 (Dutch).

Management Centre Europe: International cash management (including: International tax aspects in cash management). London (United Kingdom), December 6-8 (English).

Terzake Belastingen: Tax problems arising from mergers. Amsterdam (Netherlands), December 9 (Dutch).

Institut für Ausländisches und Internationales Finanz- und Steuerwesen der Universität Hamburg: Current problems in international tax law (including: development trends of double taxation treaties). Hamburg (German Federal Republic), December 9 (German).

Management Centre Europe: Stanley B. Lubman on China (including: The joint venture income tax law; the tax on individual income; the tax on foreign enterprises; recent regulations and interpretations by central and local tax authorities). Brussels (Belgium), December 9-10 (English).

U.K. Tax Congress: 2nd Annual U.K. Tax Congress (including: Current uses of U.K. offshore tax havens; taxation of commercial interest; tax deferral opportunities for individuals). London (United Kingdom), December 9-10 (English).

JANUARY 1983

British Branch of I.F.A.: Recent tax cases. London (United Kingdom), January 18 (English).

FEBRUARY 1983

British Branch of I.F.A.: Tax treatment of non-residents (Tax workshop). London (United Kingdom), February 8 (English).

MARCH 1983

British Branch of I.F.A.: Tax aspects of interest (Tax workshop). London (United Kingdom), March 2 (English).

Management Centre Europe: Managing and developing foreign subsidiaries (including: tax in international operations). Brussels (Belgium), March 28-30 (English).

APRIL 1983

The Taxation Institute of Australia: Sixth National Convention (including: The role of the High Court in interpreting tax statutes; taxation of technology; tax shelters and planning for the '80s). Melbourne (Australia), April 10-15 (English).

OCTOBER 1983

37th Annual Congress of I.F.A.: I. Tax avoidance/tax evasion. II. International problems in the field of turnover taxation. Venice (Italy), October 10-15 (English, French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

British Branch of I.F.A.: Secretariat c/o Williams & Glyn's Bank Ltd., New London Bridge House, 25 London Bridge Street, London SE1 9SX (United Kingdom).

Institut für Ausländisches und Internationales Finanz- und Steuerwesen der Universität Hamburg: Grindelhof 38, 2000 Hamburg 13 (Federal Republic of Germany).

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).

Terzake Belastingen: VNU Data publishing International bv. Antwoordnummer 18007, 1000 VB Amsterdam (Netherlands).

The Taxation Institute of Australia: 113 Swanson Street, Melbourne VIC. 3000 (Australia).

U.K. Tax Congress: 20 London Road, Horsham, West Sussex RH12 1AY (United Kingdom).

Tax Changes in Jamaica: The 1982-83 Budget

By H.W.T. Pepper

For the second year in succession the new Government in Jamaica has been able to introduce a Budget imposing no new taxes, partly because of increases in collection of tax arrears in the previous year.

Income taxes

Various changes in existing taxes have been announced although income taxes on companies and individuals have been deferred for future consideration.

Certain exemptions from income tax are, however, to be granted with effect from 1 January 1983. In the case of agriculture exemption is to be extended to all agricultural income derived from the growing of crops. (See below, "Agricultural income").

Exemption is also to be granted in respect of the employment income of all registered disabled individuals certified as substantially handicapped by injury, disease or congenital deformity where the handicap will be of indefinite duration.

Payroll contribution

A 3% levy on wages paid by employers is to be made with effect from 1 June 1982 to provide funds for H.E.A.R.T. (Human Employment and Resources Training) to train 16-to-20-year-olds who will be selected for training for periods up to 3 years.

Employers may deduct wages paid to the trainees from the H.E.A.R.T. contributions due from them, and wages and residual dues will be deductible from taxable profits.

In the second and third years instead of a deduction employers will receive tax credits of 75% of male trainees' wages (80% for female trainees' wages) a more generous allowance to encourage continuance of training programmes.

If the H.E.A.R.T. levy works as planned it will confer a net benefit, rather than a net liability, upon employers and so will rank as a kind of training subsidy rather than new taxation.

Property tax

As regards property tax, a re-valuation exercise is to be commenced in June 1982 and in due course small properties valued at $ 2,000 or less, which formerly paid a minimum tax of $ 5.00 are to exempted.

Other properties will be classified according to the type of land use and the rate structure will be adjusted so that there will be no material increase in the existing tax liability on properties.

Once the new values are established, an indexing system will be introduced so that in future values, and the tax yield, will rise with prices, creating buoyancy in the revenue from property tax.

Taxpayers whose properties are mortgaged will be afforded the facility of paying their property tax in monthly instalments to the mortgage institutions along with the monthly capital, interest, and insurance payments. The institutions will be required to pay over the tax to the collector quarterly, a system which will provide an "easy-payment plan" for taxpayers and also assist the Tax Collection Department.

Stamp duties

To cut down the amount of work involved both in the private sector and the Stamp Duty Office it is proposed to change the stamp duty on receipts from an ad valorem levy (which varies from 1 cent to 20 cents) to a flat rate levy of 3.5 cents per receipt. The levy was formerly paid by gumming postage stamps on receipts but will in future be paid by monthly composition payments.

Many other duties will also be paid by way of composition instead of by having thousands of individual documents embossed by stamping machines.

Vehicle and drivers' licences

To reduce administrative work the licensing system is to be computerised and driving licences will be issued for 3-year terms (at $ 24.00, i.e., 3 times the annual cost) instead of yearly. There will be an additional levy of $ 5.00 to cover the cost of a laminated plastic licence containing a photograph of the driver.

In the case of vehicle licences (called road tax in some countries) the fee will be payable annually without the option to pay quarterly. The owner of a vehicle will be able to retain the vehicle's licence plate throughout his life-time. When a vehicle is sold the old licence plate will be removed and a new one fixed in respect of the new owner.

Individuals' vehicle licence fees will be payable, and renewable on the first day of the month in which the individual was born, while other vehicles' licences will be renewable each 1st January.

Levies on imported vehicles

A major fiscal improvement arises from the rationalisation of initial duties and taxes on motor cars formerly subject to levies totalling 173% of c.i.f. value, with exemptions for self-drive car hire agencies and former residents of Jamaica returning to the country with a motor car.

The exemptions have now been abolished thus broadening the tax base, and the total taxation on cars not exceeding 2,000 c.c. engine capacity (petrol-driven) or 2,200 c.c. (diesel-driven) is now 75% of the c.i.f. value comprised of 45% customs duty and the remainder retail sales tax.

Cars of higher engine capacity will, however, continue to be taxed at the old rates.

Trucks, lorries, and other commercial vehicles used for agricultural purposes will continue to enjoy the exemption from all initial duties and taxes conferred in last year's Budget. Other commercial vehicles will continue to be exempted from all levies except the 45% customs duty on c.i.f. value.

Agricultural income

The considerable incentives to agriculture have been rationalised as far as the income tax exemption is concerned. Instead of specifying a period of tax holiday, a complete exemption is to be accorded, with effect from 1 January 1983, for profits from the growing of crops.

Losses incurred in exempt agricultural activities will not be available to be offset against other income and separate accounts are to be prepared for the exempt operations.

"Free trade" facilities

Jamaica's entitlement to export commodities to other countries which will accept the commodities as duty-free imports or within established quotas is likely to be extended from the CARICOM free trade area, the A.C.P. arrangements, the G.S.P. (Generalised System of Preference) agreements with Canada and the U.S.A., and other schemes by the inauguration of President Reagan's C.B.I. plan.

The C.B.I. (Caribbean Basin Initiative) arose partly from talks held by the Hon. Edward Seaga, M.P., P.C., Jamaica's Prime Minister and Minister of Finance, with President Reagan in 1981.

Basically the C.B.I. provides, for a period of 12 years, duty-free import facilities for Jamaica's (and many other Caribbean countries') exports to the U.S.A. of all goods except most textiles and garments. Textiles and garments will, however, receive favourable treatment falling short of duty-free entry. In addition the C.B.I. will give incentives to U.S. investment in the Caribbean to produce more goods for export and to finance imports of such goods by U.S. importers.

The C.B.I. scheme will come into effect when passed by the U.S. Congress.

Double taxation relief

Jamaica has double taxation treaties with the U.K. and the U.S.A., and also with Canada, Denmark, West Germany, Norway and Sweden. The treaty with Sweden is being updated and negotiations are under way for new treaties with other countries.

Erratum: Bulletin February 1982: page 52 (Section III), delete "New Zealand".

JAMAICA:

Budget 1982-83

Extracts from the Budget Speech pronnounced on 22 April 1982 by the Hon. Edward Seaga, Prime Minister and Minister of Finance and Planning.

Members of this Honourable House will recall that in the Budget Presentation of last year I indicated that among the priority objectives of my Government was the promotion of increased economic activity and towards that end tax administration and policy changes would be introduced on a phased basis.

. . .

Income tax relief

Where any person provides training and employment for one or more registered participants he will be permitted to deduct the amount of the remuneration paid to the participant from the amount of HEART Contributions[1] for which he is liable. The net HEART Contributions, if any, remaining after deduction of the participant's remuneration will be payable to the Collector of Taxes. The Net HEART Contributions and the participant's remuneration will be deductible expenses for purposes of income tax.

Where a person liable to HEART Contributions does not provide training and employment for registered participants the Gross Contributions will be payable to the Collector of Taxes and will be deductible for income tax purposes.

In order to induce continued employment of registered participants after the end of the first year of training, it is proposed that instead of treating the participant's remuneration as a deductible expense, the employer be given Tax Credits for the Second and Third years equivalent to a prescribed percentage of the participant's remuneration, which Credit would be a greater tax benefit than the effect of a deductible expense.

For the Second and Third years the prescribed percentage will be 75% and in recognition of the need to compensate for the higher rate of unemployment experienced by females in the Labour Force vis-a-vis males, the Tax Credits for the Second and Third years in respect of female participants will be 80%.

The grant of Tax Credits will be subject to certification by the HEART Fund that the participant performed satisfactorily during the relevant year and that the employer met all obligations.

. . .

1. Human Employment and Resources Training, see the preceding article by H.W.T. Pepper.

Property taxation
Land revaluation programme 1982-83

In accordance with the provisions of Section 11 of the Land Valuation Act all parcels of land in Jamaica are now due for revaluation, but apart from this fact the significant changes in the level of property values during the past eight (8) years following the date of the last revaluation now render the early revaluation of land an urgent necessity in order to establish an equitable base for the taxation of property.

Government has therefore decided that the programme of revaluation will commence in May, 1982 and the whole exercise is expected to be completed by 31st January, 1983.

The main objectives of the revaluation programme are:
(i) To update the property tax base to reflect current market values.
(ii) To establish a system of land use classification and coding of each parcel of land to facilitate taxation based on the dominant land use categories, namely:
(a) agricultural;
(b) residential;
(c) commercial;
(d) industrial.
Establishment of a land use classification will provide the basis for development of a more equitable tax structure, thereby obviating the necessity for time-consuming derating and relief procedures.
(iii) To create an inventory of agricultural properties of 50 acres and over. This size category covers 1.3 million acres or 46% of all farm land. Pilot studies have already been undertaken for the parish of St. Mary.
(v) To create an inventory of land owned by Government. The information derived from revaluation will be computerised and will include: location, area, title reference, use occupation and tenurial status, the nature of improvements and the unimproved values.
(v) To refine the existing fiscal cadastre especially in relation to enclosure maps and plans.
(vi) To code land in foreign ownership.

Tax liability after revaluation

Members should note two important aspects of the revaluation programme namely:
(i) The tax rates will be adjusted so that there should be no significant increases in the existing tax liability of property owners.
(ii) There will be no property tax on any parcel of land valued at $ 2,000 and under. Approximately 300,000 taxpayers across the island will benefit from this exemption.

Buoyancy of the property tax

On the defects of the present site value system of land taxation is its lack of buoyancy in the sense that Government derives no tax advantage from changes in the market values of land. This defect will be remedied by introducing a Land Value Indexing System concurrently with the establishment of the updated land values under the revaluation programme. This means that following the conclusion of the forthcoming revaluation exercise, there will be a continuous programme for monitoring and analysing property transactions in order to determine changes in the level of values in each land use category. The information derived under this Land Value Indexing System will:
(i) enable Government to review, as and when it deems necessary, the rate structure applicable to each use category; and
(ii) enable the Land Valuation Department:
(a) to effect future revaluation exercises in a much shorter time period and at considerably reduced cost;
(b) to improve the valuation roll maintenance operations by effecting on a regular basis changes relating to the ownership, use and subdivision of land.

. . .

Revision of the Stamp Duty Act

In continuation of the programme of revision of the provisions of taxing statutes to facilitate improvements in assessment and collection procedures, arrangements have been made for a comprehensive revision of the Stamp Duty Act which requires substantial updating in many respects having been enacted as long ago as July, 1937.

. . .

There are a number of stamp duties such as those on Life Insurance Policies and Bills of Lading which can be collected more efficiently by the method of composition. Government has, therefore, decided to facilitate the making of agreements in the future by amending the Act to empower the Stamp Commissioner to enter into agreements for the composition of stamp duties, as he thinks fit, but subject to the same terms and conditions as are applicable to the instruments now under composition arrangements.

. . .

Income tax concessions - income tax exemption: Agricultural Income

Members will recall that in the last Budget Presentation, I announced that the Agricultural Incentives Act would be amended in order to:
(i) Expand the range of agricultural crops in respect of which tax concessions were granted under the Act.
(ii) Extend the tax holiday period from 5 to 9 years on the basis of the amount of "value added" in the process of production.

. . .

Government is convinced that the initiatives for economic recovery, especially in the area of agriculture, can best be served by an exemption from income tax of the profits derived from agriculture, instead of the proposed amendments to the Agricultural Incentives Act. Initially, the exemption will be confined exclusively to the growing of agricultural crops.

. . .

Proposal for the integration of the system of collection for all items of revenue and statutory contributions

. . .

Government has, . . . decided that a more effective method of collection would be achieved if the Collection and Compliance Activities in relation to all items of Revenue and Statutory Contributions are centralized in a single Agency within the Collector General's Department adequately staffed with trained personnel and involving the establishment of an integrated Computer System.

This programme of development will be carried out on a phased basis as follows:
(i) The responsibility for the collection and enforcement of income tax in the Corporate Area will be transferred to the Collector General's Department. This will enable the Commissioner of Income Tax to concentrate on the primary functions of identifying and assessing the large number of taxpayers instead of dissipating the efforts of his organization in carrying out collection and compliance functions more appropriately executed by the Collector General's Department which is already provided with the nucleus for the centralized system of collection and compliance.
(ii) The collection of NHT contributions will be transferred from the Commercial Banks to the Collector General's Department.
(iii) The compliance activities in relation to NHT and NIS Contributions will be transferred to the Collector General's Department. This will facilitate compliance activities. This will mean the establishment in each Collectorate of a small Unit to carry out the compliance activities in relation to Income Tax, National Housing Trust and National Insurance Contributions.

BOTSWANA:

THE FINANCIAL ASSISTANCE PROGRAMME

By D.K. Uttum Corea*

Contents

A "white paper" entitled "The financial assistance policy" was presented during the April 1982 sessions of the National Assembly of Botswana. The paper sets out a policy for the development of productive employment and deals with various proposals to provide financial assistance to certain new ventures and expansions of certain existing ventures to achieve this end.

This article is based on the proposals contained in the white paper and the report of an inter-ministerial working group. The income tax amendments, mentioned in the Budget Speech for 1982/83, which have yet to be detailed in an income tax amendment bill, are also discussed in the light of the white paper. This article should be regarded as providing guidelines only. The proposals are subject to introduction of related income tax legislation in the next sessions of the National Assembly, and the information contained herein is based on my interpretation of "the financial assistance policy" and proposals for amendment of the income tax act.

I. PRODUCTIVE EMPLOYMENT DEVELOPMENT FUND

Financial assistance is to be provided by way of specific grants to eligible projects from the above fund. P5 million is included as an appropriation in the 1982/83 budget towards the funds. This is considered to be an initial appropriation toward the fund.

II. CLASSIFICATION, BY SCALE, OF PROJECTS RECOMMENDED FOR FINANCIAL ASSISTANCE

(a) small scale projects: those involving an investment of up to P10,000;
(b) medium scale projects: those involving an investment between P10,000 and P750,000;
(c) large projects: those involving an investment of more than P750,000.

Access to funds for small projects will be limited to citizens and these are likely to be most important in the rural areas.

Assistance in respect of medium and large projects is intended to primarily favour citizen-owned businesses though it would appear that foreign-owned businesses will not be excluded from consideration, thereafter. In fact it is my opinion that medium and large scale projects will invariably require foreign collaboration and that the financial assistance policy will therefore apply to all eligible ventures.

III. NATURE OF ASSISTANCE RECOMMENDED FOR THE VARIOUS TYPES OF PROJECTS

Small scale projects:

(i) The proposed assistance is to be in the form of *grants* towards capital investment and working capital of small scale industries (e.g. hammer milling, bee-keeping, cement block manufacturing, black-smithing, etc.) which have reasonable expectation of being financially viable;
(ii) The grants are to be based on a percentage of total investment cost favouring owner-operated activity in rural areas. Preference is also given to female entrepreneurs;
(iii) The grants are to be limited to a maximum of P2000 per job to be created by the project.

Medium scale projects:

(i) In the case of *new manufacturing industries* the following *automatic grants* are recommended:
   1. *A five-year "step down" tax holiday* involving reimbursements to a business of 100% of its income tax liability in each of the first two years after commencement of production, and 75%, 50% and 25% in the third, fourth and fifth years, respectively;
   2. *A "step down" reinbursement* of *unskilled labour costs* of 80% in the first two years, and 60%, 40% and 20% in the third, fourth and fifth years respectively;
   3. *A training grant* in reimbursement of 50% of off-the-job training costs in the first five years of operation (in place of existing training allowances

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for tax purposes. However, those businesses which are not eligible for training grants will retain their eligibility for training allowances for tax purposes).

Note: The grants in 2 and 3 above will be included in income for tax purposes but not the reimbursement of tax in 1 above.
Alternatively an entrepreneur contemplating investment in a new manufacturing industry may apply for substitution of the tax holiday described in 1 above with a *capital grant* and a *sales augmentation grant*, as described below, together with the automatic employment and training grants mentioned above.

(ii) In the case of all *other* expansions of existing *productive activities* and for all new investments in eligible sectors other than manufacturing the following assistance has been recommended after approval on a *case-by-case* examination basis:

(*Productive activities:* have been defined for the purpose of this policy to be activities for the production of goods which can either substitute for imported items or can be exported. These, however, exclude the cattle industry and large scale mining ventures. Effectively this limits the activities to manufacturing, medium and small scale mining and agriculture other than cattle.)

1. *Capital grants* of P1000 per job to be created in non-agricultural sectors and P500 per job to be created in agriculture.
   This grant is to be subject to the following limits:
   40% of capital investment in urban areas
   45% of capital investment in peri-urban areas
   50% of capital investment in non-urban areas
   60% of capital investment in rural area east
   70% of capital investment in rural area west;
2. *Sales augmentation grants* up to a maximum of 8% of sales revenue in each of the first two years, and 6%, 4% and 2% in years three, four and five respectively;
3. *A "step down" reimbursement of unskilled labour costs* – as detailed in the earlier section;
4. *A training grant* – as described in the earlier section.

Note: The case-by-case eligibility of the other productive activities will be evaluated by economic analysis so as to establish whether the project is in the overall economic interests of Botswana. The project would be expected to yield an economic return of at least 6% in real terms after adjustment for certain economic factors such as unskilled labour costs, import inputs, export credits, training costs, income tax and foreign investment in flows and out flows relating to the project. The economic analysis would cover a period of five years excluding any significant pre-production stage.

<u>*Large scale projects.*</u>

1. The same package of automatic assistance would apply to all *new* large scale *manufacturing* industries as in the case of similar medium scale projects.
2. A case-by-case evaluation would apply to all *other* expansions of existing *productive activities* and for all new investments in eligible sectors other than manufacturing as in the case of similar medium scale projects. A similar package of assistance is also envisaged.

Note: However, in view of the minimum size of the large scale projects the economic evaluation again based on 6% minimum yield will be over a period approximating the expected life of the initial investment generally up to a maximum of 20 years. Discounted Cash Flow (DCF) analysis would feature in the evaluation.

IV. OTHER TYPES OF ASSISTANCE

As a general rule the package of assistance will consist of those grants specified in the foregoing sections. However, some degree of flexibility is envisaged given the complex nature of some large scale projects. It is considered that for some projects protection under the terms of the Southern African Customs Union Agreement may be appropriate. Some other forms of direct and indirect assistance may be identified and requested by the potential investor.

V. LINKING INDUSTRIES

These have been described as industries which provide a marketing or collecting function for the productive sectors discussed above, e.g. Botswanacraft Marketing Co. The importance of such linking industries to the development of small scale industries has been recognised and such industries will qualify for grants after evaluation by standard methodology with some degree of flexibility given the unusual nature of such activities.

VI. LOCAL PREFERENCE

Local businesses tendering for Government contracts are currently given 12½% price preference over foreign suppliers of similar goods provided that the local product has at least 25% Botswana value added.

Businesses which are in receipt of financial assistance grants will not be eligible for local preference in Government and Parastatal procurement.

VII. EVALUATION AND MONITORING

Approval and monitoring of projects which are to be assisted by the Productive Employment Development Fund is to be carried out by:

- Local authorities - for small scale projects.
- Technical inter-ministerial committee (with later delegation to local authorities and line ministeries) - for medium scale projects.
- Committee at Permanent Secretary level – for large scale projects.

In addition to prior analysis of projects for decision making there will be follow-up evaluation to ascertain the extent to which both the policy and individual projects approved under it are meeting their objectives.

VIII PRODUCTION EMPLOYMENT DEVELOPMENT FUND POLICY PROPOSALS FOR AMENDMENT TO INCOME TAX LEGISLATION

It has been recommended that the existing lump sum capital allowances and investment allowances be replaced by straight line depreciation for all new and second-hand capital investment. This is in accordance with the budget which proposed a change in the system of capital allowances to make them neutral as between capital-intensive and labour-intensive industry.

The recommended rates of straight line depreciation are as follows:

Buildings:

(i) All buildings of industrial undertakings	15% initial allowance and the balance to be depreciated at 2½% per annum
(ii) Commercial buildings	2½% per annum;

It would appear that depreciation will not be allowed in respect of residential buildings.

Plant and machinery:

Short lived P & M (such as motor vehicles)	25% p.a.
Medium life P & M (6 - 7 years)	15% p.a.
Durable machinery	10% p.a.

I must stress, however, that any changes to income tax legislation are subject to an income tax amendment bill being presented in the National Assembly at its next sitting and debate thereon.

IX. OTHER MAIN FEATURES OF THE PROPOSED INCOME TAX AMENDMENT BILL REFERRED TO IN THE BUDGET SPEECH

(a) The extension of taxation of gains made on the transfer of certain business assets to all such assets. I interpret this as a proposed introduction of capital gains tax;
(b) A phased move to a system of current, quarterly income tax payments by the business sector;
(c) Correction of an error in the error in the provision for averaging of farming income;
(d) Revision of the provisions relating to secrecy with a view to facilitating the discovery and prevention of revenue frauds.

The detailed Income Tax Amendment Bill should be presented at the next sitting of the National Assembly.

Revised Double Taxation Convention between Australia and the United States of America *

I am pleased to be able to announce that a revised double taxation convention between Australia and the United States was signed today in Sydney. When it enters into force, this important new agreement will replace the one which has been in operation since 1953.

While the primary object of the new agreement is the avoidance of double taxation and the prevention of fiscal evasion, there are nonetheless a number of other important reasons for entering into the treaty. For example, it is an expression of accord between our Governments and reflects the close ties and goodwill that exist between our countries.

The Government has been aware of a number of shortcomings in the existing agreement, brought about largely by amendments over the years to the taxation laws of both countries and by changes in the commercial dealings. In overcoming these difficulties, the new agreement should be particularly welcomed by businessmen in both countries. Indeed, it is the Government's wish that the new agreement will not only facilitate, but will act as an incentive to, trade and investment between Australia and the United States.

The new agreement contains provisions for allocating taxing rights between the countries which are substantially similar to those obtained in Australia's other modern double taxation agreements. To the extent that the existing agreement accords with those principles of allocation, the new agreement will not result in any significant practical changes in the basis of taxing the income concerned.

For example, the taxation treatment of dividends is basically unchanged, and each country will continue to reduce its withholding tax on dividends paid to residents of the other to 15% of the gross dividend.

In somewhat similar vein, business profits which arise from the operation or maintenance of a branch that a resident of one country has in the other will continue to be taxed in the country where the branch is located. The agreement recognizes the Australian branch profits tax on branches here of U.S. and other foreign firms.

Because the new agreement, unlike the old, treats the Australian continental shelf as part of Australia for purposes of the treaty, Australia's ability to tax income of U.S. firms operating on our continental shelf is made secure.

Changes of significant practical importance which the

* Statement by the Australian Treasurer, the Hon. John Howard, M.P., 6 August 1982.

new agreement will effect include those relating to the taxation of interest and royalties. Unlike Australia's (and other countries') modern agreements, the existing Australia/U.S. agreement does not contain provisions dealing with the taxation of interest. Nor, apart from rules under which copyright royalties are taxed only in the country of residence, are there existing provisions dealing with rights to tax royalties.

In line with modern practice the new agreement expressly recognizes the right of the country of source to tax interest and royalty income flowing to the other country but limits source country tax to 10% of the gross payment. As is customary, this limit will not apply to income effectively connected with a branch that the recipient has in the country of source. The country of residence of the recipient will also tax interest and royalties liable to tax of 10% in the country of source, but will allow a credit against its own tax for the tax paid to the country of source.

Other examples of income which may be taxed by the country of source include income from real property (including income from the exploitation of natural resources) or from the disposal of real property and most social security and government pensions.

Income from employment (including directors' fees) will be taxed in full in the country where the work is carried out, except that in specified circumstances income derived during visits of short duration to one of the countries will be taxed only by the country of residence of the particular employee.

Australia has, by the new agreement, bettered its ability to tax visiting U.S. entertainers. The new agreement provides for income derived by visiting public entertainers to be taxed in the country visited where the total income received by them in respect of their performances, including expenses, exceeds US$10,000 or its equivalent in Australian dollars. Under the existing agreement, entertainers are not taxed in the country visited unless their visit exceeds 183 days, or they are employed by a resident of the country visited or of a third country.

The new agreement provides that some types of income may be taxed only by the country of residence of the recipient. Items falling into this category include shipping and airline profits derived from international operations; pensions (other than social security and government pensions), annuities and other similar remuneration; and payments to students undertaking full-time education, made for their maintenance or education.

Unlike the existing agreement, the new treaty does not include provisions specifically covering taxation of the remuneration of professors and teachers of one country who are visiting the other. Under the new arrangements, this income will be dealt with in accordance with the general provisions covering income for services rendered.

There are also a number of changes of a more technical kind.

A special provision of the new agreement, aimed at attempted abuse of treaty provisions will limit, in specified circumstances, the benefits available under the agreement where companies are used in an attempt to exploit those benefits.

Yet other provisions of the agreement call for the allocation of income between a permanent establishment and its head office, and between associated enterprises, to be on the "arm's length" basis. In particular, Australia's right to apply its recently enacted anti-profit shifting provisions is specifically safeguarded.

Another new feature in the agreement is the inclusion of an article expressing each country's best intentions that, in enacting taxation measures, it will not treat citizens or residents of the other country, and enterprises or companies owned wholly or partly by them, in a less favourable way than it treats its own citizens or residents, enterprises or companies. This article will not affect the operation of existing provisions of the income tax law, or similar provisions enacted after signature of the convention, or provisions designed to prevent avoidance or evasion of taxes.

While the article will not be able to be called in aid by a taxpayer in an objection against a taxation assessment, it does provide for consultation between the Governments of both countries where any taxation measures are considered to infringe the principles of the particular article.

As is the case at present, the new agreement contains provisions outlining procedures to be followed where a taxpayer considers that his taxation is not in accordance with the agreement and for the relief of double taxation where, under the agreement, income may be taxed in both countries.

For example, Australia is to give credit – as it does now – for United States tax on dividends received by Australian individuals, Australian companies being effectively tax-free on dividends from the United States.

As is customary, the legislation giving the force of law to the agreement in Australia will provide for the credit method of relief to apply to interest and royalties derived by Australian residents where the United States tax on the income is limited by the terms of the agreement to 10%. Other non-dividend income that Australian residents derive from the United States will continue to be exempt from Australian tax if taxed in the United States.

The exchange of information provisions of the new agreement represent yet another area of change. This valuable aid to the taxation administrations of the two countries now will extend to information appropriate in the general enforcement of each country's income tax laws.

The new agreement will enter into force upon exchange of instruments of ratification, which can only occur after the Australian parliament and the U.S. Senate have approved the agreement. Once the agreement has been ratified, the new arrangements covering income flows between the United States and Australia will have effect with respect to dividends, interest and royalties derived on or after the first day of the second month following the date of entry into force and, in relation to other forms of income, for taxation years commencing on or after the first day of the second month following the date of entry into force.

Copies of the agreement will be made available to interested persons at Taxation Offices in the capital cities.

UNITED STATES:
Overview of Federal Excise Taxes

Contents

INTRODUCTION

This pamphlet, prepared by the staff of the Joint Committee on Taxation, provides a summary of present Federal excise taxes. It also shows recent historical trends in Federal excise tax collections and projected excise tax revenues. The pamphlet is intended to provide summary information on Federal excise taxes for Members of the House Committee on Ways and Means, the Senate Committee on Finance, and other Members of Congress. Part I of the pamphlet is an overview of Federal excise taxes, with a brief discussion of the types of Federal excises and how some of the excises are earmarked for certain expenditure purposes. Part II is a summary of present Federal excise taxes by category: organized into 13 categories, plus a category of miscellaneous excises. The summary of each excise tax category indicates whether the revenues from the tax go into the general fund or into a trust fund or other special fund. Part III presents data on recent trends in Federal excise tax revenues for selected fiscal years, 1970-1981, and estimated revenues for fiscal years 1982 and 1983 under present law.

A forthcoming staff pamphlet will provide additional background information regarding Federal excise taxes, including an historical survey of major Federal excise tax changes, a more detailed description of present law excise taxes and the applicable trust funds, and legislative history of the specific excise taxes.

I. OVERVIEW OF FEDERAL EXCISE TAXES

Types of Federal excise taxes

The Internal Revenue Code of 1954, as amended, provides for more than 50 different excise taxes (Code subtitles D and E). In general, these are taxes imposed on the manufacture, sale or use of a particular commodity or service. Occupational taxes and penalty taxes[1] imposed on certain other activities (e.g., certain prohibited transactions of pension plans and self-dealing transactions of private foundations) are also provided as excise taxes.

Where an excise tax applies to a manufacture, sale or use, the rate of tax is a prescribed dollar amount per commodity unit (e.g., 4 cents per gallon of gasoline), a prescribed percentage of the selling price, or a variant of these basic structures. A partial listing of commodities or services to which an excise tax applies includes certain diesel fuel, truck bodies and parts, gas guzzling automobiles, tires, inner tubes, gasoline, lubricating oils, coal, fishing equipment, bows and arrows, firearms and ammunition, telephone service, airline passenger tickets, wagers, certain chemicals, crude oil, distilled spirits, wines, beers, cigars, and cigarettes.

Where an excise tax is an occupational tax, the tax is imposed as an annual amount (e.g., $123 per year for wholesale dealing in beer). Such taxes apply to certain occupations involving wagers, alcoholic beverages, and firearms.

Excise tax revenues

In fiscal year 1980, Federal excise tax revenues (excluding the windfall profit tax) amounted to $18.37 billion. Eighty percent of this amount was collected from the six excise taxes imposed on gasoline, distilled spirits, cigarettes, airline passenger tickets, beer, and telephone service. Excise tax revenues for fiscal year 1980 including the windfall profit tax were $24.33 billion.

The relative importance of excise taxes (other than the windfall profit tax) to the Federal budget has diminished over the past two decades. In fiscal year 1960, excise tax collections accounted for 13 percent of net budget receipts. By fiscal year 1970 this figure had declined to 8 percent, and by 1980, to 4 percent. This trend has been influenced by the repeal of numerous excise taxes in 1965: constant, per-unit tax rates or reduced tax rates for many other excise taxes; and the relative growth of payroll and individual income tax revenues over the period.

State governments have relied on excise taxes more heavily than the Federal Government. In 1980, State government revenues from excise taxes on selected products (principally gasoline, tobacco products, alcoholic beverages, insurance premiums, and public utility services) and general sales amounted to $68.86 billion. These collections accounted for 32 percent of the own-source revenue of State governments.

Local governments collected $12.07 billion, or 8 percent of their own-source revenue, from excise taxes on selected products and general sales in 1980.

Transfer of revenue to trust funds

In some cases, excise tax revenues are transferred to a trust fund in order to finance specified trust fund expenditures. The general intent of such trust fund excise taxes is to place the excise tax burden on persons who are most likely to benefit from such expenditures or on persons whose activities may have necessitated the expenditures.

Trust funds currently financed (in whole or in part) by certain excise tax revenues are the Black Lung Disability Trust Fund, the Hazardous Substance Response Trust Fund, the Highway Trust Fund, the Inland Waterway Trust Fund, the Land and Water Conservation Fund, and the National Recreational Boating Safety and Facilities Improvement Fund. Present law also provides for the future funding of the Deep Seabed Revenue Sharing Trust Fund and the Post-Closure Liability Trust Fund with certain excise tax revenues. Excise tax collections funded the Airport and Airway Trust Fund from July 1, 1970, through September 30, 1980.

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* Prepared by the Joint Committee on Taxation staff for the House Ways and Means and Senate Finance Committees.

1. The various penalty excise taxes (chapters 41-44 of the Code) make up 16 of the total excise taxes.

II. SUMMARY OF PRESENT FEDERAL EXCISE TAXES

A. Alcohol Excise Taxes

Overview

Under present law, excise taxes are levied on the production or importation of three types of alcoholic beverages: distilled spirits, wine, and beer. Also, an occupational tax is imposed on the persons involved with the production or marketing of alcoholic beverages.

Revenues collected from the alcohol excise taxes, most of which are from the tax on distilled spirits, go into the general fund of the Treasury.

Tax rates

Tables I and II are a summary of the excise tax rates imposed on alcoholic occupational taxes.

B. Tobacco Excise Taxes

Overview

Excise taxes are imposed on cigars, cigarettes, and cigarette papers and tubes manufactured in or imported into the United States.

Revenues collected from these tobacco excise taxes, most of which are collected from the tax on small cigarettes, go into the general fund of the Treasury.

Tax rates

Table III is a summary of the excise tax rates imposed on tobacco products.

C. Highway Trust Fund Excise Taxes

Overview

Excise taxes are imposed on certain motor fuels, lubricating oil, trucks and truck trailers, truck parts, tires and tubes, tread rubber, and the use of heavy duty highway vehicles. In general, exemptions from these taxes are provided for nonhighway use.

Under present law, revenues from these highway-related excise taxes are deposited into the Highway Trust Fund through September 30, 1984, after which time these taxes are scheduled (unless otherwise extended) to decline (generally to pre-Trust Fund rates) or to expire.

Tax rates

Table IV is a summary of present highway-related excise tax rates.

D. Aviation Excise Taxes

Overview

The Airport and Airway Revenue Act of 1970 imposed or increased the aviation excise taxes

Table I – Alcohol Beverage Taxes

Item	Tax rate
Distilled spirits	$10.50 per proof gallon.
Beer	$9.00 per barrel generally.[1]
Still wines:	
Up to 14% alcohol	17 cents per wine gallon.
14 to 21 percent alcohol	67 cents per wine gallon.
21 to 24 percent alcohol[2]	$2.25 per wine gallon.
Champagne and sparkling wines	$3.40 per wine gallon.
Artificially carbonated wines	$2.40 per wine gallon.

1. $7 per barrel for certain small brewers.
2. Wines containing more than 24 percent alcohol are taxed as distilled spirits.

Table II – Alcohol Occupational Taxes

Item	Tax rate
Brewers	$110 a year: $55 for less than 500 barrels a year.
Still manufacturers	$55 a year, plus $22 per still.
Wholesale dealers:	
Liquors and wines	$255 a year.
Beer	$123 a year.
Retail dealers:	
Liquors and wines	$54 a year.
Beer	$24 a year.

Table III – Tobacco Excise Taxes

Item	Tax rate
Cigars:	
Small cigars	75 cents per thousand.
Large cigars	8½ percent of wholesale price, up to $20 per thousand.
Cigarettes:	
Small cigarettes	$4 per thousand (8 cents per pack).
Large cigarettes	$8.40 per thousand.
Cigarette papers	½ cent per 50 papers.
Cigarette tubes	1 cent per 50 tubes.

Table IV – Current Highway User Excise Taxes and Scheduled Rates of Tax under Present Law

Tax	Rate of tax, present law: Before Oct. 1, 1984[1]	Rate of tax, present law: After Sept. 30, 1984[2]
Petroleum products:		
Gasoline	4 cents/gallon	1.5 cents/gallon.
Diesel fuel	4 cents/gallon	1.5 cents/gallon.
Special motor fuels	4 cents/gallon	1.5 cents/gallon.
Lubricating oil	6 cents/gallon	6 cents/gallon.
Trucks and truck parts:		
Trucks and trailers	10 percent of manufacturer's sale price	5 percent of manufacturer's sale price.
Parts and accessories	8 percent of manufacturer's sale price	5 percent of manufacturer's sale price.
Tires, tubes and tread rubber:		
Tires for highway vehicles	9.75 cents/pound	4.875 cents/pound.
Laminated tires	1 cent/pound	1 cent/pound.
Other tires	4.875 cents/pound	4.875 cents/pound.
Inner tubes	10 cents/pound	9 cents/pound.
Tread rubber	5 cents/pound	No tax.
Use tax on heavy vehicles	$3 per 1,000 pounds per year, if more than 26,000 pounds.	No tax.

1. Revenues are deposited into the Highway Trust Fund.
2. Revenues would be deposited into the general fund of the Treasury, unless the Trust Fund is extended.

for a 10-year trust fund period, 1970-1980. The Act also established the Airport and Airway Trust Fund for deposit of the aviation-related excise taxes. On October 1, 1980, many of the aviation excise taxes expired or were reduced, and the deposit of the aviation tax revenues into the Trust Fund was terminated at that time.

Currently, there is a 5-percent excise tax on domestic air transportation of persons, the revenues from which go into the general fund of the Treasury. There are also taxes applicable to gasoline used by noncommercial aviation and taxes on aircraft tires and tubes; these revenues currently go into the Highway Trust Fund.

Tax rates

Table V shows the present law aviation excise tax rates and the prior law Trust Fund tax rates.

E. Environmental Excise Taxes

1. Taxes for Hazardous Substance Response Trust Fund

Overview

Under present law, excise taxes are imposed on crude oil and certain chemicals, and the revenues from these taxes are deposited into the Hazardous Substance Response Trust Fund. These provisions were enacted in the Comprehensive Environmental Response, Compensation, and Liability Act of 1980.

The crude oil tax of 0.79 cent per barrel is imposed on the receipt of crude oil at a U.S. refinery, the import of crude oil and petroleum products, and the use or export of domestically produced crude oil (if the tax has not already been paid).

The tax on chemicals is imposed on the sale or use of 42 specified organic and inorganic substances if they are produced in or imported into the United States. The taxable chemicals generally are chemicals that are hazardous or chemicals the use of which may create hazardous products or wastes. The rates vary from 22 cents per ton to $4.87 per ton. (See table, following.)

The taxes generally will terminate on September 30, 1985. However, the taxes will be suspended during calendar years 1984 or 1985, if, on September 30, 1983, or 1984, respectively, the unobligated trust fund balance exceeds $900 million, and the unobligated balance on the following September 30 will exceed $500 million, even if these excise taxes are suspended for the calendar year in question. Further, the authority to collect taxes will terminate when cumulative receipts from these taxes reach $1.38 billion.

Tax rates on chemicals

The excise tax rates on certain chemicals are as shown in the following table.

Table V – Aviation Excise Taxes under Present and Prior Law

Tax	Present rate[1]	Prior Trust Fund rate (July 1, 1970-Sept. 30, 1980)
Air passenger ticket tax	5 percent	8 percent.
Air freight	No tax	5 percent.
International departure tax	No tax	$3 per person.
Fuels tax for noncommercial (general) aviation:		
Gasoline	4 cents/gallon	7 cents/gallon.
Nongasoline	No tax	7 cents/gallon.
Aircraft use tax (annual)	No tax	$25 per plane, plus weight tax.[2]
Aircraft tires tax	4.875 cents/pound	5 cents/pound.
Aircraft tubes tax	10 cents/pound	10 cents/pound.

1. Under legislation reported by the House Committee on Ways and Means (H.R. 4800, H.R. Rep. No. 97-510), the following aviation excise taxes and rates would apply for the period, July 1, 1982 to December 31, 1983 (and the revenues would go into the Airport and Airway Trust Fund for the same period):

Air passenger ticket tax	5 percent.
Air freight waybill tax	5 percent.
International departure tax	$5 per person.
Fuels tax for noncommercial aviation - (gasoline and nongasoline)	12 cents/gallon.
Aircraft tires tax	4.875 cents/pound.
Aircraft tubes tax	10 cents/pound.

2. 3½ cents per pound for turbine-powered (jet) aircraft and 2 cents per pound for nonturbine-powered aircraft for each pound in excess of 2,500 pounds of "maximum certificated takeoff weight."

Excise Tax Rates on Certain Chemicals

Chemical	Tax per ton
Acetylene	$4.87
Benzene	4.87
Butane	4.87
Butylene	4.87
Butadiene	4.87
Ethylene	4.87
Methane	3.44
Napthalene	4.87
Propylene	4.87
Toluene	4.87
Xylene	4.87
Ammonia	2.64
Antimony	4.45
Antimony trioxide	3.75
Arsenic	4.45
Arsenic trioxide	3.41
Barium sulfide	2.30
Bromine	4.45
Cadmium	4.45
Chlorine	2.70
Chromium	4.45
Chromite	1.52
Potassium dichromate	1.69
Sodium dichromate	1.87
Cobalt	4.45
Cupric sulfate	1.87
Cupric oxide	3.59
Cuprous oxide	3.97
Hydrochloric acid	.29
Hydrogen fluoride	4.23
Lead oxide	4.14
Mercury	4.45
Nickel	4.45
Phosphorus	4.45
Stannous chloride	2.85
Stannic chloride	2.12
Zinc chloride	2.22
Zinc sulfate	1.90
Potassium hydroxide	.22
Sodium hydroxide	.28
Sulfuric acid	.26
Nitric acid	.24

2. Tax for Post-Closure Liability Trust Fund

Effective after September 30, 1983, an excise tax of $2.13 per dry weight ton will be imposed on hazardous waste which is received at a qualified hazardous waste disposal facility and which will remain at the facility after its closure. These tax receipts are to be deposited into the Post-Closure Liability Trust Fund. These provisions were enacted in the Comprehensive Environmental Response, Compensation, and Liability Act of 1980.

Authority to collect the tax will be suspended for any calendar year after 1984, if the unobligated balance in the Trust Fund exceeds $200 million on the preceding September 30. Further, authority to collect the tax will terminate when cumulative receipts from the crude oil and chemical excise taxes described in the previous section reach $1.38 billion.

F. Black Lung Trust Fund Excise Taxes

Overview

Present law imposes a manufacturers excise tax on domestically mined coal (other than lignite) which is sold or used by the producer of the coal. Amounts equal to the revenues collected from this tax are automatically appropriated to the Black Lung Disability Trust Fund.[2] The coal excise tax was enacted in the Black Lung Benefits Revenue Act of 1977, and increased in the Black Lung Benefits Revenue Act of 1981.

Tax rates

The rate of tax is the lesser of (1) $1 per ton for coal from underground mines and 50 cents per ton for coal from surface mines or (2) 4 percent of the price for which the coal is sold. Present law provides that the rate of tax is to be reduced to the pre-1982 tax rates on January 1, 1996, or, if earlier, on the first January 1 after 1981 as of which there is no balance of repayable advances made to the trust fund from the general fund of the Treasury and no unpaid interest on such advances. This reduced tax rate will be the lesser of (1) 50 cents per ton for coal from underground mines and 25 cents per ton for coal from surface mines or (2) 2 percent of the price for which the coal is sold.

G. Gas Guzzler Tax

Overview

Present law imposes an excise tax on passenger automobiles that fail to meet prescribed fuel efficiency standards. The tax was enacted as part of the Energy Tax Act of 1978, applicable to 1980 and later model year automobiles. The tax is imposed at annually increasing rates through model year 1986. (See Table VI.) Revenues from the gas guzzler tax go into the general fund of the Treasury.

Table VI – Rate of Gas Guzzler Tax by Model Year

Model year	Fuel economy rating (in miles per gallon)	Tax
1982	At least 18.5	0
	At least 17.5 but less than 18.5	$200
	At least 16.5 but less than 17.5	350
	At least 15.5 but less than 16.5	450
	At least 14.5 but less than 15.5	600
	At least 13.5 but less than 14.5	750
	At least 12.5 but less than 13.5	950
	Less than 12.5	1,200
1983	At least 19	0
	At least 18 but less than 19	350
	At least 17 but less than 18	550
	At least 16 but less than 17	650
	At least 15 but less than 16	800
	At least 14 but less than 15	1,000
	At least 13 but less than 14	1,250
	Less than 13	1,550
1984	At least 19.5	0
	At least 18.5 but less than 19.5	450
	At least 17.5 but less than 18.5	600
	At least 16.5 but less than 17.5	750
	At least 15.5 but less than 16.5	950
	At least 14.5 but less than 15.5	1,150
	At least 13.5 but less than 14.5	1,450
	At least 12.5 but less than 13.5	1,750
	Less than 12.5	2,150
1985	At least 21	0
	At least 20 but less than 21	500
	At least 19 but less than 20	600
	At least 18 but less than 19	800
	At least 17 but less than 18	1,000
	At least 16 but less than 17	1,200
	At least 15 but less than 16	1,500
	At least 14 but less than 15	1,800
	At least 13 but less than 14	2,200
	Less than 13	2,650
1986 and thereafter	At least 22.5	0
	At least 21.5 but less than 22.5	500
	At least 20.5 but less than 21.5	650
	At least 19.5 but less than 20.5	850
	At least 18.5 but less than 19.5	1,050
	At least 17.5 but less than 18.5	1,300
	At least 16.5 but less than 17.5	1,500
	At least 15.5 but less than 16.5	1,850
	At least 14.5 but less than 15.5	2,250
	At least 13.5 but less than 14.5	2,700
	At least 12.5 but less than 13.5	3,200
	Less than 12.5	3,850

The tax does not apply to certain emergency vehicles or automobiles classified as nonpassenger automobiles under rules precribed by the Secretary of Transportation. Small manufacturers of automobiles (those who produce fewer than 10,000 vehicles a year) may apply to the Secretary of Treasury for special treatment for a model year, if it is not possible for the manufacturer to meet the applicable tax-free fuel economy standards with respect to some or all of its models for that year.

Tax rates

Table VI shows the gas guzzler tax for the applicable fuel economy standards in each model year for model years 1982-1986.

H. Crude Oil Windfall Profit Tax

Overview

The windfall profit tax is a temporary excise tax on the removal of domestically produced taxable crude oil from the premises on which it was produced. All domestically produced taxable crude oil is classified in one of three tax tiers. The method of determining the tax is essentially the same for all tiers: the tax is equal to the taxable windfall profit multiplied by the applicable tax rate. The taxable windfall profit is generally equal to the selling price of the oil minus an adjusted price and an adjustment for State severance taxes. The windfall profit on any barrel of crude oil cannot, however; exceed 90 percent of the net in-

2. Misuse of a black lung benefit trust due to self-dealing (sec. 4951), expenditures for an improper purpose (sec. 4952) or excessive contributions to a trust (sec. 4953) by the producer triggers certain penalty excise taxes. Amounts equal to the revenue collected under these penalty taxes, which historically have been very small, are also automatically appropriated to the Black Lung Disability Trust Fund.

come attributable to that barrel. The applicable tax rate differs among the various tiers, as does the adjusted base price. All base prices are adjusted for inflation. Certain kinds of producers are either exempt from the tax, or are eligible for reduced rates of tax on all or part of their production. The tax was enacted in the Crude Oil Windfall Tax Act of 1980.

Oil subject to tax and rates of tax

Tier one oil generally is all oil which whould have been lower or upper tier oil had previous price controls been continued, and any other oil not included in tiers two or three. Tier two oil is all oil which qualifies as stripper oil or which is attributable to production from a Petroleum Reserve.[3] Tier three oil is newly discovered oil, heavy oil, and incremental tertiary oil.

The tax rate applied to the windfall profit is 70 percent for tier one oil, 60 percent for tier two oil, and 30 percent for tier three oil. Newly discovered oil is subject to a reduced windfall profit rate. This rate which is currently 27.5%, will be reduced to 15 percent by 1986. Independent producers are allowed reduced rates on up to 1,000 barrels a day of their combined production of tier one and tier two oil from working interests. For tier one oil, the reduced rate is 50 percent, and for tier two oil the reduced rate is 30 percent.

Exemptions. – State and local governments, certain qualifying charitable medical facilities, educational institutions, and certain qualifying child care facilities, and Indian tribes and Indians over whom the United States exercises trust responsibilities are exempt from the tax. There also are exemptions for new oil produced in most of Alaska, for front-end tertiary oil, for independent stripper oil, and for a certain amount of royalty owners' production.

Phaseout of tax. — The windfall profit tax phases out over a 33-month period beginning after December 31, 1987, or when cumulative revenues raised by the tax reach $227.3 billion, whichever is later. However, the phaseout will begin no later than January, 1991.

I. Inland Waterways Fuel Tax

Overview

Present law imposes a retailers excise tax on diesel and other liquid fuels used by commercial cargo vessels on 26 specified inland or intracoastal waterways of the United States. Included among the 26 waterways are the Mississippi River upstream from Baton Rouge, the Mississippi's tributaries, and the Gulf and Atlantic Intracoastal Waterways. The revenues from this tax are deposited into the Inland Waterways Trust Fund. The tax was enacted in the Inland Waterways Revenue Act of 1978.

The tax does not apply to fuel used by deep-draft ocean-going vessels, recreational vessels, or noncargo vessels such as passenger vessels and fishing boats. In addition, fuel used by tugs in moving LASH and SEABEE ocean-going barges carrying international cargoes is exempt.

Tax rates

The present tax rate is 6 cents per gallon. That rate was first effective on October 1, 1981. On October 1, 1983, the rate is scheduled to increase to 8 cents per gallon. On October 1, 1985, the tax will increase to 10 cents per gallon.

J. Land and Water Conservation Fund Taxes; National Recreational Boating Safety and Facilities Improvement Fund

1. Land and Water Conservation Fund

Present law provides for the transfer of certain tax and other government receipts to the Land and Water Conservation Fund. There are no separate taxes imposed specifically for this purpose. The amounts transferred to the fund are:

(1) An amount equal to the 4-cents-per-gallon tax on gasoline and special fuels derived from such fuels used in motorboats (except for certain amounts transferred to the National Recreational Boating Safety and Facilities Improvement Fund, described below, for fiscal years 1981-1983);[4]

(2) Generally, proceeds received from any disposal of surplus real property and related personal property under the Federal Property and Administrative Services Act of 1949, as amended;

(3) Certain miscellaneous receipts under the Outer Continental Shelf Lands Act; and

(4) Revenues from Federal recreation fee collections (since January 1, 1981).

2. National Recreational Boating Safety and Facilities Improvement Fund (Boating Safety Fund)

The Secretary of the Treasury is authorized to pay into the Boating Safety Fund amounts equivalent to the motorboat fuel taxes on gasoline and special motor fuels (4 cents per gallon) received on or after October 1, 1980, and before October 1, 1983. The aggregate amount transferred to the Fund during any fiscal year is not to exceed $20 million, and no amount is to be transferred if such transfer would result in increasing the amount in the Fund to a sum in excess of $20 million. Any amount received in the Highway Trust Fund which is attributable to motorboat fuel taxes and which is not transferred from the Highway Trust Fund under these provisions is to be transferred into the Land and Water Conservation Fund provided for in Title I of the Land and Water Conservation Fund Act of 1965.

K. Sporting Goods and Firearms Excise Taxes

Overview

1. Excise taxes on sporting goods and regular firearms

Under present law, there are excise taxes imposed on the sale by a manufacturer, producer, or importer of certain fishing equipment, bows and arrows, pistols or revolvers and other regular firearms, and ammunition (shells and cartridges). Revenues attributable to these taxes are distributed in grant programs to States for certain fish and wildlife restoration and development projects.

Tax rates

Table VII is a summary of the excise tax rates on sporting goods and regular firearms.

Table VII – Excise Taxes on Sporting Goods and Regular Firearms

Item	Tax rate
Fishing equipment (rods, creels, reels, and artificial lures, bait and flies)	10 percent.
Bows and arrows (and accessories)	11 percent.
Pistols and revolvers	10 percent.
Firearms (other than pistols and revolvers)	11 percent.
Ammunition (shells and cartridges)	11 percent

3. The reference continued in the Crude Oil Windfall Profit Tax Act of 1980 should have been to a "Naval" Petroleum Reserve. This reference is proposed to be corrected in the Technical Corrections Act of 1982 (H.R. 6056), which has been ordered reported by the House Committee on Ways and Means.

4. See also summary of the excise taxes on gasoline and special fuels included in section C. on the Highway Trust Fund Excise Taxes.

2. Excise taxes on non-regular firearms

Overview

There are also special excise taxes imposed to regulate machine guns, destructive devices (e.g., bombs, grenades, mines, etc.) and certain other firearms (e.g., shotguns or rifles under a certain length). These consist of occupational taxes (annually), transfer taxes, and a "making" (producing) tax.

Tax rates

Table VIII is a summary of excise taxes on non-regular firearms.

Table VIII – Excise Taxes on Non-Regular Firearms

Item	Tax rate
Occupational taxes:[1]	
Importers	$500 per year
Manufacturers	$500 per year
Dealers	$200 per year
Transfer taxes:	
Generally	$200 per transfer
Certain concealable weapons (sec. 5845(e))	$5 per transfer
Making tax	$200 per firearm

1. An importer, manufacturer, or dealer in certain concealable weapons only are taxed (under sec. 5845(e)) as follows: $25 per year per place of business for importers and manufacturers; and $10 per year per place of business for dealers.

L. Communications (Telephone) Excise Tax

Present law imposes a 1-percent excise tax on amounts paid for local telephone service, toll telephone service and teletypewriter exchange service. Revenues from the tax go into the general fund of the Treasury.

Exemptions from the tax are provided for communications services furnished to news services (except local telephone service to news services is not exempt), international organizations, the American National Red Cross, servicemen in combat zones, nonprofit hospitals and educational organizations , and State and local governments. Other exemptions include amounts paid for installation charges and for certain calls from coin-operated telephones.

This excise tax is scheduled to terminate, effective with respect to amounts paid pursuant to bills first rendered on or after January 1, 1985.

M. Wagering Excise Taxes[5]

Under the present law, a two-percent excise tax is imposed on the amount of certain wagers. For this purpose, a wager means (1) a wager placed with a person who is in the business of accepting wagers on the outcome of a sporting event or contest, (2) a wager with respect to a sporting event or contest placed in a wagering pool conducted for profit, and (3) a wager placed in a lottery conducted for profit (including the numbers and similar types of wagering). However, this excise tax is not imposed on (1) wagers placed with a parimutuel wagering enterprise licensed under State law, (2) wagers placed in coin-operated gaming devices, such as slot machines, and (3) State-conducted wagering, such as sweepstakes and lotteries. Under present law, the two-percent excise tax is imposed on so-called off-track betting authorized by State law.

In addition, an occupational tax of $500 per year is imposed on each person who is liable for the two-percent excise tax on wagers and on each person who is engaged in receiving wagers for or on behalf of such person.

N. Miscellaneous Excise Taxes

Overview

There are several miscellaneous excise taxes under present law, including penalty excises on certain transactions or activities of certain tax-exempt organizations or other trusts, an excise tax on net investment income of private foundations, a deep seabed excise tax on certain minerals, and an excise tax on foreign insurance policies.

Specific miscellaneous excise taxes

1. Penalty excise taxes. – A number of penalty excise taxes are imposed on certain organizations or trusts if they engage in certain transactions or activities, or if they fail to take particular required actions. These excise tax sanctions (at varying rates) are imposed on certain lobbying activities of public charities, certain private foundation activities, and on black lung benefit trusts, qualified pension, etc. plans, and real estate investment trusts. Revenues from these penalty excise taxes go into the general fund of the Treasury.

2. Excise tax on private foundation net investment income. – There is a 2-percent excise tax imposed on a private foundation's net investment income. A foreign organization which is a private foundation is subject to a 4-percent excise tax on gross investment income derived from sources within the United States. Revenues from this tax go into the general fund of the Treasury.

3. Deep seabed excise tax. – An excise tax is imposed on the removal from the deep seabed of certain hard mineral resources pursuant to a deep seabed permit issued under the Deep Seabed Hard Mineral Resources Act of 1980. Hard mineral resources are mineral nodules lying on or just below the surface of the deep seabeds, which contain one or more specified minerals (manganese, nickel, cobalt, or copper).

The tax is equal to 3.25 percent of 20 percent (or 0.65 percent) of the fair market value of the commercially recoverable minerals removed. Revenues will go into the Deep Seabed Revenue Sharing Trust Fund. (No revenues are currently expected to be received prior to 1988.)

This excise tax will terminate on the earlier of the date on which an international deep seabed treaty takes effect with respect to the United States, or 10 years after the date of enactment of the Tax Act (June 28, 1980).

4. Excise tax on foreign insurance policies. – An excise tax is imposed on certain policies issued by any foreign insurer or reinsurer to or for a U.S. corporation, partnership or individual with respect to risks wholly or partly within the United States, or to or for any foreign personel engaged in business within the United States with respect to risks within the United States.

The tax is imposed at the rate of: (1) 4 cents per dollar of premiums paid on the policy of casualty insurance or the indemnity bond; (2) 1 cent per dollar of premiums paid on a policy of life, sickness, or accident insurance, or annuity contract (unless the insurer is subject to tax under Code section 819); and (3) 1 cent per dollar of premiums paid on the policy of reinsurance covering any of the contracts taxable under (1) or (2) above. Revenues from the tax are deposited in the general fund of the Treasury.

5. There is a Senate amendment to H.R. 4717, currently pending in a House-Senate conference committee, which would reduce the two-percent tax to 0.25 percent for wagers authorized by State law. Also, the $500 occupational tax would be reduced to $50 in the case of persons authorized by State and local law to accept wagers in a wagering business authorized by State law. Otherwise, the present two-percent and $500 taxes would continue to apply.

III. FEDERAL EXCISE TAX REVENUES

Budget Receipts From Federal Excise Taxes for Selected Years, By Fund and By Tax, Fiscal Years 1970-1983

(Millions of dollars)

	Actual				Estimated	
Excise tax	1970	1975	1980	1981	1982	1983
Federal (General) Funds						
Alcohol taxes:						
Distilled spirits	3,445	3,830	3,919	3,819	4,182	4,080
Beer	1,076	1,305	1,545	1,604	1,672	1,644
Rectification tax[1]	25	22	8	([2])	—	—
Wines	180	172	211	244	243	245
Liquor occupational taxes	20	22	21	21	21	21
Refunds	–136	–113	–104	–82	–84	–87
Total alcohol taxes	4,610	5,238	5,601	5,606	6,034	5,903
Tobacco taxes:						
Cigarettes	2,036	2,261	2,403	2,539	2,694	2,622
Cigars	57	51	40	40	40	40
Cigarette papers and tubes	1	1	1	1	1	1
Other	1	1	3	3	3	3
Refunds	–1	–3	–4	–3	–3	–3
Total tobacco taxes	2,093	2,312	2,443	2,581	2,735	2,663
Manufacturers (non-trust fund) excise taxes:						
Gasoline	28	29	31	32	30	30
Passenger automobiles[3]	1,753	—	—	—	—	—
Firearms, shells, and cartridges	33	51	75	97	90	99
Fishing rods, creels, etc.	14	22	34	23	37	40
Pistols and revolvers	7	11	22	27	27	30
Bows and arrows	—	4	6	7	7	7
Gas guzzler tax	—	—	2	([4])	1	1
Windfall profit tax	—	—	5,959	23,220	24,196	21,275
Refunds	–6	–12	–6	–18	–98	–48
Total manufacturers excise taxes	1,829	105	6,122	23,459	24,290	21,434
Miscellaneous excise taxes:						
General and toll telephone and teletype service	1,470	2,024	1,118	999	796	656
Transportation of persons	251	—	—	—	—	—
Wagering taxes, including occupational taxes	5	6	12	13	16	20
Employee pension plans	—	—	3	5	3	3
Sugar tax[4]	113	104	—	—	—	—
Coin-operated gaming devices[5]	14	7	—	—	—	—
Interest equalization tax[6]	86	2	—	—	—	—
Tax on foundations	—	65	68	90	80	78
Foreign insurance policies	9	19	75	75	86	97
Other (including repealed taxes)	3	1	2	1	1	1
Refunds	–24	–23	–32	–75	–20	–10
Total miscellaneous excise taxes	1,926	2,204	1,246	1,108	962	845
General fund collections associated with aviation taxes[7]	—	—	—	1,180	1,265	1,458
Undistributed Federal tax deposits and unapplied collections	–106	–460	152	194	143	222
Total Federal (general) fund excise taxes	10,352	9,400	15,563	34,128	35,429	32,525

(continued)

Budget Receipts From Federal Excise Taxes for Selected Years, By Fund and By Tax, Fiscal Years 1970-1983

(Millions of dollars)

	Actual				Estimated	
Excise tax	1970	1975	1980	1981	1982	1983
		Trust Funds				
Highway Trust Fund:						
Gasoline	3,447	4,069	4,011	4,016	3,978	3,928
Trucks, buses,[8] and trailers	700	602	912	664	847	1,184
Tires, inner tubes and tread rubber	643	797	680	644	653	662
Diesel fuel used on highways	263	402	523	561	575	613
Use tax on heavy highway vehicles	137	221	277	237	264	270
Truck parts and accessories	87	143	253	234	305	338
Lubricating oil	109	100	105	101	105	105
Refunds	–32	–146	–142	–152	–145	–143
Total Highway Trust Fund taxes	5,354	6,188	6,620	6,305	6,582	6,957
Airport and Airway Trust Fund:[7]						
Transportation of persons	—	779	1,601	—	—	—
Waybill tax	—	54	92	—	—	—
Tax on fuels	—	54	70	—	—	—
International departure tax	—	55	92	—	—	—
Aircraft use tax	—	20	21	—	—	—
Tires and innertubes taxes	—	1	1	—	—	—
Refunds	—	–1	–3	—	—	—
Total Airport and Airway Trust Fund taxes[7]	—	962	1,874	21	—	—
Black Lung Disability Insurance Trust Fund	—	—	272	237	507	612
Inland Waterways Trust Fund	—	—	—	20	58	67
Hazardous Substances Response Trust Fund	—	—	—	128	283	299
Total trust fund excise taxes	5,354	7,151	8,766	6,711	7,43	7,935
Total Excise Taxes	15,705	16,551	24,329	40,839	42,859	40,640

Note: Details may not add to totals because of rounding.

1. The rectification tax was repealed in the Trade Agreements Act of 1979.
2. $500,000 or less.
3. The excise tax on passenger automobiles was repealed in the Revenue Act of 1971.
4. The excise tax on sugar expired in 1975.
5. The tax on coin-operated gaming devices was repealed in the Revenue Act of 1978.
6. The interest equalization tax expired in 1974.
7. The aviation excise taxes going into the Airport and Airway Trust Fund (July 1, 1970 through September 30, 1980) either expired or were reduced on October 1, 1980. The revenues from the current 5-percent air passenger ticket tax now go into the general fund; and the revenues from the 4-cents a gallon tax on general aviation gasoline and taxes on aircraft tires and tubes now go into the Highway Trust Fund. (The figures for 1982 and 1983 do not include the revenue effects of proposed legislation affecting the aviation excise taxes; neither Administration proposal nor H.R. 4800 as reported by the House Committee on Ways and Means.)
8. The tax on buses was repealed in the Energy Tax Act of 1978.

Source: The Budgets of the United States Government for Fiscal Years 1972, 1977, 1982, and 1983.

BANGLADESH:

Budget 1982-83

Extracts from the Budget Speech pronounced by Mr. A.M.A. Muhith, Minister of Finance and Planning, on 30 June 1982.

A detailed discussion of the Bangladesh tax system appears in the International Bureau of Fiscal Documentation's publication: TAXES AND INVESTMENT IN ASIA AND THE PACIFIC.

. . .

Now I would present the policy and decisions regarding fiscal measures for the coming financial year. The role of foreign aid in the development of the economy is undoubtedly very important, but for bringing about economic transformation of an economy, the overall fiscal policy of the Government is a fundamental element. For increasing the investment for productive purposes with reduced dependence on foreign aid, increased mobilisation of internal resources is necessary. But it is to be borne in mind that we have a very limited number of people having surplus income and the vast majority of the people can hardly make their both ends meet and languish in miseries.

2. The following basic principles have been adopted in formulating proposals for the fiscal measures of the Government:

- To provide relief for the poor people as far as possible from the burden of taxes.
- To help the domestic industry to expand and augment production and introduce measures in conformity with this policy.
- To bring about rationality and equity in the tax administration.
- To simplify the method of tax collection making it comprehensible to the common taxpayers.
- To reduce the area of discretion with a view to ensuring logical and rational approach thereby saving the taxpayers from avoidable harassment.
- Multiplicity of taxation points to be reduced. Customs duty and sales tax should be realised at import point, excise duty should be realised at production premises and similarly all direct taxes should be realised at one point.
- Tax policy should be geared up as a tool for accelerated mobilisation of internal resources.
- All surplus and taxable income should be brought under tax net. While there is a necessity of effective and equitable tax administration, there should be inducements for increasing the willingness on the part of the taxpayers to pay taxes.

3. For formulating a correct and balanced fiscal policy, I have received suggestions and advice from different sections of the society. Chief Martial Law Administrator, his Ministers and other advisors have also offered guidelines and suggestions. In many cases, in harmonisation of different objectives the ideal solutions could not be achieved. Formulation of a fiscal policy is not a matter of few months, it requires continuous study and exercise throughout the whole year. We have decided to utilise the newly formed Consultative Committee for Mobilisation of Internal Resources more fruitfully in future. For **simplification of the principles and procedures adopted or applied in realising tax, considerable time is required. My effort was to make a beginning of the process of simplification and rationalisation and to widen the process in those areas where the work of simplification has already initiated.**

4. We believe that, for changing the lot of the people, establishment of new industries and increase of industrial production side by side with increase in agricultural produces is a must. In order to simplify the process to achieve this goal, decisions have been taken for rationalisation and simplification involving major changes in customs duties. In taking these decisions, the rate of augmentation of internal resources, ability to pay tax by the people, overall need of the country, stabilisation of the price level and steady flow of commodities have been taken into account.

CUSTOMS DUTY

5. In order to eliminate the existing stagnation in the field of production of the domestic industries and to transform it into a viable, productive and income generating sector by utilising the idle capacity, the duty on many imported raw materials have been reduced quite substantially. In the cases of those commodities where domestic production is not adequate to meet the requirement of the economy, the duty rates on such imported finished goods have been adjusted reasonably. These measures, it is hoped, will protect the interest of the domestic industry on the one hand and ensure adequate availability of goods within the country on the other. I believe that the industrialist of the country will take full advantage of these facilities and make an all-out effort to augment the domestic production of these articles. The increase in production will have a favourable effect on the efficiency of the production method bringing about reduction in the cost of production and increase in profit. The policy of protecting the interest of the domestic industry has not been kept confined in the sphere of customs alone, but has also been equally applied in the field of excise and the price control. The facilities thus given are quite substantial and the nation expects that the industrialists of the country will take full advantage of this policy not only to advance their own interest but also extend the benefit to the vast masses of the country. Government shall expect from the producers of the essential commodities to fix the retail price of their products and notify those to the general public:

(1) In consideration of the fact that thermoplastic moulding compound is a raw material for a wide range of industries and extensive use thereof is capable of having a salutory effect on the economic development of the country, the duty on the item is reduced to 40% from the existing 75%. Duty on shoe and cable grade PVC however has not been changed in view of their domestic production. On the same ground duty on urea formaldehyde adhesive has been raised to 100%.

(2) In order to help domestic industry produce more at a reasonable cost, the duty on bright, medium and high carbon steel wire and wire rods have been reduced to 40% from the existing 60%. On the other hand, duty on pipes, tubes, nuts, bolts, screw, rivet, welding electrodes, etc. have been enhanced from 35% and 100% to 50% and 150% respectively.

(3) In order to protect the interest of the domestic producers, the duty on sanitary wares of iron and steel has been raised to 150% from the existing 100%.

(4) The existing duty differential between the imports of CKD and finished trucks and buses being not adequate, the duty on built-up trucks and buses has been raised to 50% from the existing 35%. However, in order to ease problems of transportation in the urban area duty on mini-buses has been reduced to 20%.

(5) In order to save the domestic industry engaged in production of pumps from the uneven competition with the imported goods, duty on pumps have been raised and unified at 50%.

(6) With a view to encouraging the domestic assemblers, duty on CKD refrigerators and deep-freezers is reduced to 75% from existing 100% and that on built-up sound recorders and reproducers has been raised to 100% keeping the duty rate on CKD imports of the same at 75%.

(7) There is a sizeable capacity within the country for production of milk and milk products which remains under-utilized because of the uneven competition with the imported goods. In order to provide advantage to the local dairy products, duty on aluminium foil and polythene film is reduced to 10% from the existing 50% and 100% on certain conditions. Further, duty on imported liquid and semi-liquid milk is raised to 20% from the existing 10% and that on cheese and butter to 40% from the existing 25%.

(8) For the benefit of the domestic film industry, the duty on the imported exposed cinematographic film has been raised and fixed at Taka 5.00 per metre.

(9) With the commencement of domestic production of the items, duty on acetyle salicylic acid B.P. and piperazine citrate has been raised to 50% from the existing 10%. This will be applicable to the imports of pharmaceutical industries also.

(10) To help attain self-sufficiency in its domestic production the duty on mosquito coil and napthalene ball has been raised to 50% and 75%, respectively.

(11) It is in the interest of the economy of the country to take necessary measures to protect the interest of the domestic textile industry. In order to achieve this objective, duty on wool and synthetic tops and nylon chips has been reduced to 20% from the existing 75%, on the other hand duty on imported cotton yarn has been

reduced to an unified rate of 20% from the existing 25% and 35%. In order to help domestic spinning industry to reduce its cost of production, the total incidence of duty and sales tax on raw cotton has been reduced and fixed at 10% customs duty with no sales tax.

(12) Measures have also been taken to help the ailing cycle industry of the country by way of increasing the duty on imported built-up bicycle to 75% from the existing 50% and rationalising the duty on the components and parts of bicycle by fixing it at 20% in lieu of the existing 15% and 50%. Duty on writing and duplicating ink has also been enhanced to 155%.

(13) In order to boost up the production of tar obtained from petroleum it is necessary to refix the duty on the imported coal tar. As such the duty on the later has been raised to 50% from the existing 25%.

(14) Encouragement of assembling of cassettes domestically is necessary for saving foreign exchange spent on account of import of cassettes. To help this industry, duty on parts and components of cassettes has been reduced and fixed at 50%.

(15) In order to encourage domestic production of pesticide and insecticide in a greater scale, duty on the raw and packing materials of the industry engaged in its production has been fully exempted in case of raw materials and reduced to 20% in case of packing materials.

(16) Pulp is the basic raw material of the domestic paper mills, for safeguarding the interest of which, duty on the item is reduced to 10% from the existing 15%. Similarly, the duty on the imported finished spectacle frames has been enhanced to 100% from the existing 75%.

(17) With a view to protecting the interest of the steel mill, the customs duty on imported billets has been raised to 50% from the existing 40%.

(18) Duty on copra, which is a raw material for production of coconut oil is reduced to 10% from the existing 40%.

(19) Duty on finished medicines and allied goods has been raised to 20% from the existing 10% in view of their local production.

6. It is the declared policy of the Government to simplify, rationalise and modernise the tariff structure. In order to achieve this objective, a number of steps have been taken in this year's budget. I believe that these steps would go a long way in alleviating many anomalies, disputes, misunderstandings paving the way for introduction of a smooth, simple and understandable customs administration:

(1) At present there are more than 23 rates of customs duties which have now been reduced to 12. There, however, remain a few exceptions which could not be removed because of revenue consideration or protection to domestic industry. In due course, further simplification will be considered.

(2) Vegetable oils excepting palm karnel, coconut and crude degummed soyabean oil which attracted the duty rate of 25% have now been subjected to duty @ 40%. Duty on coconut and crude degummed soyabeen oil has been reduced to 20% while that on palm karnel oil has been enhanced to 50%. Duty on Horlics and Ovaltine has been rationalised to the rate of 40% from the existing 5%.

(3) Medical, surgery and hospital equipments attracting duty rates of 10%, 15% and 25% have now been subjected to a unified duty rate of 20%.

(4) Fabrics in which the total content of cotton is 85% or more at present attract different rates of duties of 30%, 75%, 125% and 150% depending on various factors. These rates have now been unified at 75%.

(5) The ship-builders in the nationalised sector enjoy a conditional duty free facility which has been abolished bringing them at par with the ship-builders in the private sector. Now they will have to pay the duty on their imports and on production of proof of the use of their imported materials in the building of ship, shall get refund of duty paid in excess of 20%. M.S. plate, however, shall not be entitled to this refund facility.

(6) The duty on man-made fibre has been rationalised and up-dated at Taka 2.20 per kg. from the existing Tk. 1.00 per lb and 150%.

(7) Duty on essential oils and its mixtures has been made uniform at 200% from the existing 125%, 150% and 200% depending on its tariff classification.

(8) The duty rates of factory ships and trawlers have been rationalised and made uniform at 2½% from existing 15% and 2½% respectively.

(9) The tariff values on coloured and black and white television and refrigerator and deep-freezer have been enhanced and up-dated at Taka 500.00, Taka 200.00 per inch and Taka 500.00 per cft. respectively.

(10) The duty on scraps of iron and steel, rerollable scraps and ship for breaking purpose have been enhanced and unified at 20% from the existing 12½% and 17½%.

(11) The conversion rate between the foreign currency and Bangladesh currency often gives rise to the necessity for raising demand subsequent to the clearance of the goods because of the non-availability of day-to-day exchange rate by the customs authority. With a view to removing this nagging problem, necessary amendment in law has been made enabling the customs authority to accept the average monthly exchange rate of the preceding month. Certain other amendments in law have also been made to rationalise and modernise certain provisions of law.

(12) From now on, in case of the machinery imported for the initial installation of an industry, the transaction value will be accepted by the customs authority for assessment purpose. It is hoped that this measure will remove lot of dispute and misunderstanding.

7. The wide imbalance in the export earnings and import bills of the country is one of the biggest problems faced by us. All possible efforts should be made to reduce the import by increasing the industrial capacity to produce more within the country, by restricting the import of non-essential articles. The steps that have been taken in this regard are aimed at achieving this objective. The efforts that have been initiated in the Export Policy have been stated in details by the Minister of Commerce and Industry a few days back. I would like to mention only about three steps taken in the budget to boost up the export. Total exemption of duty has been accorded on the exports of tea and raw jute. In order to give a boost to the export of finished leather, a system has been devised under which the exporter of the finished leather who has been able to raise his export by 20% over that of the previous year will be entitled to export wet blue leather also at a special concessionary rate of 2½%. Further, with a view to augmenting export of frozen fish, duty on imported factory ships has been reduced to 2½% from the existing 15%.

8. While the need for mobilization of domestic resources remains paramount, duty on many non-essential goods are comparatively quite low. In consideration of greater national need for mobilization of domestic resources, duties on these articles have been raised:

(1) Duty on petrol motor-car having engine capacity of over 850 c.c. but not over 1000 c.c. has been raised to 100% from 75%; duty on petrol motor-cars up to 1300 c.c. has been raised to 150% from existing 125%. Motor-cars having engine capacity over 1300 c.c. will now be dutied @ 300%. The luxury cars having air-conditioners and other luxury gadgets will continue to attract higher rates of duty.

(2) For the benefit of thousands of villagers producing betelnuts, the duty on this item has been increased to Taka 20.00 per kg. from the existing Taka 11.00 per kg. The duty on plants and parts of trees required for pharmacy has been fixed at 10% withdrawing the existing full exemption. Duties on fishing hooks, grease and lubricating oil have also been enhanced respectively from existing 30% and 20% to 100% and 40%. In view of the ban imposed on the import of drycell batteries, the tariff value fixed earlier on the item has been withdrawn.

(3) Duty on cigarette paper has been raised to 150% from the existing 100% but at the same time the sales tax on the item has been reduced to 10% from the existing 20%.

(4) Last year in order to meet the deficit in the budget, development surcharge @ 1% was imposed on all dutiable imports. This year also similar necessity exists for which this rate of surcharge has been enhanced to 2%. This measure is likely to yield an additional revenue of Taka 30 crores.

9. The fiscal measures which have been discussed above are likely to yield a gross revenue of Taka 62.83 crores and would entail a revenue loss of Taka 21.8 crores giving net revenue gain of Taka 41.75 crores in customs duty.

SALES TAX

10. Sales tax law has been completely recast. The new Ordinance will invest the Customs Department with the administration of sales tax in its entirety. From the coming financial year, sales tax will exclusively be levied on the imported goods and there will be only two

rates of sales tax, i.e. 20% and 10%. In the present budget substantial exemptions and reductions of sales tax have been accorded as a result of which the revenue loss of the exchequer on this account will be Taka 36 crores. On the other hand, sales tax have been imposed on certain items of raw materials which enjoy exemption from excise duty. Besides, as a consequence of the decisions taken in respect of customs duty, the collection of sales tax on certain items will also increase. The total gain in sales tax as a result of the aforesaid measures has been estimated at Taka 44 crores bringing the net gain on this account at Taka 8 crores.

EXCISE DUTY

11. I would like to draw your attention to a few of the steps that we have taken with regard to excise duties. A number of changes has been made in the rates of duties and their underlying principles are as follows:

In the first place, to stop harassment of small traders and producers excise duty has been withdrawn from autogarages, wooden furniture, services rendered by decorators and caterers, tanned leather and leather products (except footwear), syrups, squashes and fruit juices, banking services excepting cheques, bottling of unscented cocoanut oil, ultramarine blue and dyes. To encourage cottage industries the range of excise duty exemption has been widened. The ceiling of capital has been raised from Taka 10,000 to Taka 50,000 for such cottage industries. For purposes of income tax assessment the same definition will be applicable.

Secondly, for administrative efficiency excise duty has been withdrawn in some cases, and in some other cases, duties have been merged. For example, duty has been withdrawn on cellophane, plastic and resin materials excepting four items. These four items are: PVC pipes, Rexin cloth, insulation boards and telephone sets on which duty @ 30% and ad val. has been retained. In case of rubber products duty has been retained @ 30% ad val. on three items rubber belt, pipes and foam, and duty has been withdrawn from the rest of the items. On glass and glasswares three rates have been fixed: 30% for glass sheet, 5% for amber glass bottles and 10% for others by replacing the different rates of duty (5%, 10%, 20% and 30%). The existing exemptions will, however, continue. The other aim of allowing such concessions is to help boosting of production. Duty rates on metal containers used in production process have been merged and reduced to 10% ad val.

Thirdly, duty has been exempted or reduced on some items for the convenience of the people, specially the lower income group. Duty on paper has been reduced from 15% to 10% ad val. and on motor-cycle from 7½% to 5% ad val. Duty is also withdrawn from bitumen emulsion and Alkatra made out of local bitumen.

Fourthly, after complete abolition of sales tax on local produced or manufactured goods, arrangements have been made to maintain Government revenue through excise duties. Cutlery, stainless steel crockeries, steel pine, G.I. pipe, asbestos pipe, sheet and other asbestos products, oxygen and other gases, sodium silicate and glycerine will now be subjected only to excise duty at the rate of 20% ad val. The other four items, viz., mechanically propelled four-wheeled vehicles, tarpaulin, steel billets and steel ingots will be subjected to excise duty at the rate of 10% ad valorem.

Fifthly, as I have aready stated all sales tax will be collected at the import stage. Some raw materials are now exempted from payment of sales tax. With the change in this condition excise duty has been reduced to lighten the burden of tax:

(a) Excise duty on vanaspati ghee and edible oil payable respectively, at the rate of Taka 50 and Taka 5 per cwt. is completely withdrawn.
(b) Duty on paints, pigments and varnishes has been reduced from 30% of the retail price to 20% of the retail price.
(c) Duty on mechanically manufactured soap has been reduced from the existing 20% and 10% to 5% of the retail price, and that on non-mechanically produced soap payable at the rates of 20% and Taka 20 per maund has been fully exempted. Duty on detergents has been reduced from 20% to 10% of the retail price, and that on jute batching emulsifier has been fixed at 5% of the retail price.
(d) Duty on electric bulbs has been reduced from Taka 12, 15 and Tk. 36 per dozen to Tk. 6, Tk. 7.80 and Tk. 18 per dozen respectively. Similarly, duty on fluorescent tubes has been reduced from Tk. 10.75, Tk. 8, Tk. 8.50 and Tk. 5.50 per tube to Tk. 5.50, Tk. 4, Tk. 4.25 and Tk. 2.725 per tube respectively.
(e) The existing duty of Tk. 9, Tk. 7.20 and Tk. 6 per dozen of primary cells and batteries has been reduced to Tk. 4.80, Tk. 3.60 and Tk. 3 per dozen respectively.
(f) Various rates of excise duty on man-made fibres and yarn have been totally withdrawn and this item has been made fully exempted from excise duty.
(g) Duty on perfumery, cosmetics and toilet preparations has been reduced from the existing 35% and 25% to 20% of the retail price, and in some cases it has been reduced from 25% to 10% of the retail price.

Sixthly, steps have been taken to simplify procedure in certain respects. For example, the duty and licence fee which used to be collected on narcotics and liquors has now been merged into duty. The excise duty and Development Surcharge on petroleum products have been merged. Duty on diesel oil, kerosene and furnace oil has been raised by five poisha per gallon. In place of the existing four rates of 2½%, 5%, 10% and 15% on hotels and restaurants, two rates of 10% and 20% have been fixed. The exemption ceiling of duty in case of hotels and restaurants has been made realistic. If the rent per room per day exceeds Tk. 50 in place of Tk. 10 and if the gross sale exceeds Tk. 50,000 per month in case of hotels and restaurants respectively, they will be assessable to duty.

12. Some steps have been taken to increase revenue:

(i) Existing excise duty of Tk. 1 per lb. on tea has been refixed at Tk. 3 per kg. Additional duty of 10% and 15% which is leviable on relatively costlier packet tea will, however, continue.
(ii) Duty-rate on sugar has been fixed at 10% ad val. in place of the existing Tk. 70 cwt.
(iii) Duty-rate on matches has been fixed at Tk. 3 in place of the existing Tk. 2 per gross.
(iv) In case of gold jewellery the capacity duty rates haves been refixed in place of–
(a) Tk. 15,000 + Tk. 1,000 for every 100 tolas or fraction thereof at Tk. 24,000 + Tk. 1,000.
(b) Tk. 15,000 at Tk. 24,000.
(c) Tk. 10,000 at Tk. 15,000.
(d) Tk. 6,000 at Tk. 9,000.
(e) Tk. 3,000 at Tk. 4,500.
(f) Tk. 1,000 at Tk. 1,500.
(g) Tk. 500 at Tk. 700.

Similarly, in case of bullion dealers the rates have been refixed in place of:
(a) Tk. 15,000 + Tk. 2,000 at Tk. 25,000 + Tk. 2,000.
(b) T. 15,000 at Tk. 22,500.
(c) Tk. 10,000 at Tk. 15,000.
(d) Tk. 6,000 at Tk. 9,000.
(e) Tk. 4,000 at Tk. 6,000.
(f) Tk. 2,000 at Tk. 3,000.

(v) At present natural gas is used in a few cities and industries. Gas users are getting a lot of advantages in respect of price in comparison to those to whom gas is not available. As such duty on gas has been raised from Tk. 14.00 to Tk. 17.50 only per one thousand cft., and for power generation and fertilizer production the rate has been refixed at Tk. 9.00 in place of Tk. 6.00 per 1000 cft.
(vi) Pharmaceutical industry has reached a stage where the question of its remaining untaxed no longer seems justified. Excise duty has been imposed on allopathic medicine (except vaccines and contraceptives) at the rate of 5% on the retail price.
(vii) Duty has been imposed on insecticide, pesticide, germicide and antiseptic other than those used for agricultural purposes at the rate of 5% of the retail price.
(viii) Glucose, dextrose and starch are being produced in the country on a large scale and these industries have become quite profitable. It has therefore been decided to impose excise duty at the rate of 10% ad val. on these products.
(ix) Welding electrodes used mainly in industries, are being produced in the country on quite a large scale and its remaining out of tax net does not appear to be reasonable. Excise duty at the rate of 20% ad val. has therefore been imposed on welding electrodes.
(x) Chinawares and porcelainwares are paying excise duty at the rate of 30% ad val. at present. But glazed claywares, similar in appearance and use to chinaware and porcelainware, are offering a good enough competition to China and porcelain products. But there is not duty on this item. As such, excise duty at the rate of 30% ad val. is imposed on glazed potteries.
(xi) A regulatory duty on comparatively higher quality cigarettes is imposed at the rate of 5% of the retail price if such price exceeds Taka two and poisah eighty per packet of ten sticks of cigarettes.

(xii) Duty on foreign liquor, country liquor, mritasanjibani sura, ganja, bhang and opium has been enhanced slightly over the present rate. The rate of duty on rectified spirit has also been enhanced slightly. But the concessionary duty rate on rectified spirit, used in homeopathic and allopathic medicines, has been retained. At the same time, steps have been taken to stop the tendency on large-scale misuse of this concessionary rate.

13. Sales tax has been exempted fully on the following items, viz.:
(a) Brass and copper sheet and zinc sheet, (b) table lamp, (c) wall-clock and time piece, (d) musical instruments, (e) chocolates, toffees and lozenges, (f) sweet-meats, (g) slacked and unslacked lime, (h) brass and copper handicrafts, (i) industrial chemicals, (j) ice-cream, (k) decorated brass and copper light fittings, (l) tea trolleys, (m) torch-light, torch-light case, and hook rings, (n) printing ink, (o) R.C.C. pipe, (p) conduit pipe, (q) electrical fittings.

14. There is some talk on entertainment tax. It is said that the arrangement is really old-fashioned and there is no correlation between the duty-rates and reality. It is possible to fix entertainment tax on the capacity of cinema halls. We want to have discussions with the cinema hall owners and the film exhibitors. Under these circumstances, no change in the rates of duty on entertainments has been considered.

15. An amount of nearly Tk. 22 crores will be collected less on account of exemption and reduction in the rates of excise duty. Of course, for new impositions and few enhancements of the rates of duty, nearly Tk. 45 crores will be collected. As a result, there will be a net increase in revenue of Taka twenty three crores approximately.

INCOME-TAX AND OTHER DIRECT TAXES

16. At present there are only two lakh eighty thousand assessees in our country. The direct taxes constitute only a small portion of the total revenue earnings. The corporate sector contributes nearly 75% of the income-tax.

The income-tax laws are complex and the Act itself is outdated. The procedure of determining income is complicated. The system of tax collection is not particularly streamlined. The improvement of the system will be both difficult and time consuming:

- We hope to re-write the Act in the near future and public opinion in this regard will be solicited.
- Last year, attempts were made to bring new assessees into the tax-fold through the introduction of self-assessment scheme and reduction in the rate of tax.
- The same effort will continue this year also. Proposals have been taken for the simplification of the method of calculation of tax.
- A number of measures have also been taken to encourage investment.
- The Estate Duty Act has been repealed.
- The responsibility of collection of income-tax, gift-tax and wealth-tax will be entrusted to the same authority.
- Stamp duty leviable on the transactions in the shares market has been exempted.
- Rates or scope of gift-tax, wealth-tax and urban immovable property tax have been substantially reduced.
- Efforts to merge urban immovable property tax with other prevalent rates will be taken up in the near future.

17. In order to reduce the burden of tax the following measures have been adopted:

(1) In the context of inflationary situation, the maximum exemption limit of income seems to be low. It is, therefore, decided to enhance the present limit from Tk. 15,000 to Tk. 20,000 to alleviate the hardship of the lower income group.

(2) In order to reduce the burden of tax the personal taxation rates have been substantially scaled down. As a result, an individual having income of Tk. 50,000 will now pay tax of Tk. 2,750 only as against Tk. 4,000 payable under the existing rate provided the benefit of maximum investment is allowed in both the cases. But without any investment allowance the tax on the same income will be Tk. 8,500 and Tk. 6,750 under the old rates and new rates respectively. The tax rates in the case of registered firms have also been reduced. The maximum rebate of tax on export sales has been enhanced.

(3) In order to remove the difficulties of the small investors, the restrictive provision regarding the initial allowance of Tk. 5,000 and 60% on the balance of investment has been withdrawn.

(4) Considering the increase in the cost of conveyance, the rates of conveyance allowance in the case of salaried persons have been raised from Tk. 1,800 to Th. 2,400, Tk. 2,400 to Tk. 3,200 and Tk. 4,200 to Tk. 6,000.

(5) The rate of tax on capital gains arising from the sale of assets after 2 years but within 5 years of acquisition and after five years of acquisition have been reduced from the existing 35% and 30% to 25% and 20% respectively. Besides, the rate of tax on capital gains arising after 15 years of acquisition of the asset has been fixed at 15%. It has also been decided to withdraw the provision of exempting of capital gains from sale of assets acquired before the 14th August 1947.

(6) Gratuity has been totally exempted from the payment of tax in line with the exemptions already granted to pensions.

(7) A new provision has been made in the Act for exemption on payments made to Zakat Fund and contributions made to the Charitable Fund established under the Zakat Fund Ordinance, 1982.

(8) By the Finance Act, 1980, a provision was made for obtaining licence on payment of Tk. 100 by all persons carrying on business, profession or vocation from a premise, whether their income is below or above the exemption limit. This provision has been withdrawn for the benefit of traders and professionals with income below the exemption limit.

18. The following measures have been taken with a view to facilitate investment:

(1) In the interest of the country's industrialisation the capital gains arising out of sale proceeds of land and buildings have been exempted from payment of tax provided these are invested in the setting up of new industrial undertakings.

(2) Royalty and technical know-how fee have also been exempted from payment of tax in order to encourage industrialisation.

(3) The conditions required to be fulfilled for the admissibility of bonus as an expenditure have been waived in the case of festival bonus.

(4) The provision of accelerated depreciation introduced by the Finance Ordinance, 1977 which expires on the 30th June, 1982 is extended for another five years in the interest of industrialisation.

(5) For the purpose of exemption of cottage industry the maximum investment limit has been raised from Tk. 10,000 to Tk. 50,000.

19. The measures taken for the rationalisation and simplification of assessment procedure are as follows:

(1) In order to simplify the assessment procedure earned income relief, children education allowance and personal allowance have been withdrawn. However, the consequential loss has been made good through adequate reduction in the tax rates.

(2) To widen the scope of self-assessment, the present maximum limit of Tk. 25,000 has been raised to Tk. 50,000. The salaried directors of limited companies have also been made eligible for self-assessment.

(3) the provision of presumptive assessment introduced by the Finance Act, 1980 has failed to achieve the desired result. It has also become redundant after the reintroduction of self-assessment scheme. Hence, the provision of presumptive assessment has been withdrawn.

(4) In order to alleviate the hardship of the lower income group the present limit of income for advance payment of tax has been raised from Tk. 25,000 to Tk. 50,000.

(5) In order to exclude the lower income group from the requirement of filing a statement of assets and liabilities along with the return of income, the present limit of income for this purpose has been raised from Tk. 25,000 to Tk. 50,000.

(6) The rate of interest payable by the Government on the excess payment of advance tax has been raised from 10% to 13½% per annum.

(7) In view of the rising prices of real estate the present requirement for obtaining clearance certificate where sale value exceeds Tk. 50,000 has been raised to Tk. 100,000.

(8) The restrictive provision regarding the date of commencement of construction for the purpose of exemption of newly constructed residential building has been withdrawn.

(9) In order to simplify the calculation of annual value of self-occupied property, a suitable amendment has been made in the Act.

(10) In future income from bus, truck and launch will be computed on the basis of capacity of each transport. This will remove a lot of misunderstanding.

(11) A new system will be evolved for realisation of taxes from the travel agencies.

Airlines having business transaction with the travel agencies will be made responsible for deduction of tax at source at the time of making payments to such agencies.

(12) The Income-tax Appellate Tribunal will hear appeals in the concerned districts where necessary.

GIFT TAX

20. As regards gift tax, the following measures have been taken:

(1) In order to rationalise the present provisions of tax free gifts to father, mother, real sons and daughters up to Tk. 300,000 and to spouse up to Tk. 100,000 it has been decided to merge these two exemptions into one. The maximum limit has been fixed at Tk. 400,000.

(2) Considering the rising cost of living, it has been decided to raise the exemption limit of gift from Tk. 20,000 to Tk. 25,000 per year.

(3) In order to simplify the existing rate structure, it has been decided to reduce the number of slabs from 6 to 4. The rate of tax on each slab has also been modified.

WEALTH TAX

21. The following measures have been taken with a view to reducing the burden of wealth-tax:

(1) The present exemption limit in the case of self-occupied residential house has been raised from Tk. 1,500,000 to Tk. 2,500,000 in view of the present inflationary situation and to alleviate the hardships of the persons of limited means.

(2) Under the present provisions the aggregate of income-tax and wealth tax can not exceed 60% of the total income of an assessee, only if his taxable income exceeds Tk. 150,000. This restrictive provision is unnecessary and hence withdrawn.

ADVERTISEMENT TAX

22. At present employment and tender notices published in daily newspapers are exempt from advertisement tax. It has been decided to extend this exemption so as to include any notice connected with employment and also advertisements made by the educational institutions such as notice of admission, notices of commencement of examinations, academic sessions etc.

URBAN IMMOVABLE PROPERTY TAX ACT

23. At present holdings with annual value not exceeding Taka 6,000 are exempt from urban immovable property tax. In order to give some relief to the owners of small holdings the ceiling of exemption has been raised to Tk. 18,000 for holdings within the Dacca Metropolitan area and to Tk. 12,000 for holdings in all other areas. Moreover in order to reduce the tax burden on the owners of holdings the rate of tax has been reduced in the case of holdings not being self-occupied from 4% to 3% of annual value and in case of self-occupied holdings from 2% to 1½% of the annual value.

24. The reduction in the burden of tax and the simplification of the collection procedure have been made with the hope that these will motivate larger number of taxpayer to pay their taxes. These are also expected to curb the tendency and the scope of evasion of tax and also to augment the revenue collection. The provision of declaration of untaxed income is also expected to yield additional revenue. It is, therefore, estimated that the total collection of revenue only from income-tax will amount to Tk. 300 crores.

STAMP DUTY

25. At present the rate of share of transfer fee under Stamp Duty Act, 1899 is 1.5% on the value of the shares. This transfer fee acts as a deterrent to the transactions of shares in the Stock Exchange. It is decided to remit the duty chargeable under the said Act on the shares of Public Limited Companies listed in the Stock Exchange with effect from 1-7-82. A separate order will be issued in this respect.

MOTOR VEHICLE TAX

26. The existing rates of motor vehicle taxes and fees are very low. Tolls are collected from a very few bridges. Hence it has been decided to enhance the rates of tax on motor vehicles and to abolish the system of collection of toll from bridges. An additional collection under this head is estimated to be Tk. 2.25 crores.

FOREIGN TRAVEL TAX

27. In order to remove the burden of the wage-earners, it has been decided to exempt return tickets purchased abroad in foreign currency from payment of foreign travel tax.

LAND DEVELOPMENT TAX

28. The provision of tax collection introduced by the Land Development Tax Ordinance, 1976 is unrealistic. Agricultural development has been the mainstay of our economy during the last decade. The present pace of development leaves scope for further improvement and requires increased investment in the agricultural sector. Land is our main asset. Unless we can tap adequate revenue from this sector it would not be possible to generate enough savings for further investment. Agriculture contributes nearly 56% of our Gross Domestic Product. It would not be possible to accelerate development process unless savings are generated from this sector. Most of the landed properties are controlled by a limited number of people. Farmers having four to six bighas of land are considered to be self sufficient, while those having land exceeding fifteen bighas are considered to be surplus farmers and fairly rich. But a person owning lands upto 25 bighas is required to pay land development tax at Tk. 1 only per bigha. This state of affairs needs a radical change. The rate of tax on land should be progressive and the landowners should pay tax at an increased rate. The best way is to impose tax on the basis of productivity of land. But this cannot be done because of the dearth of necessary documents and administrative machinery.

29. We have long been talking about raising the rate of land development tax. We also believe that this will ensure efficiency in the use of land. We have, therefore, decided to increase the rate of land development tax with effect from 1-7-82. Measures have been taken to realise more revenue from both urban and rural lands. The revenue yield from urban land will be about Tk. 13 crores. There will be three rates of tax: one for Dacca, Chittagong and Khulna, another for the District towns and yet another for the rest of the towns. The rate of tax will also be different for residential and commercial lands. Different slabs have been prescribed for agricultural land namely, upto 6 bighas, then 6 to 15, in excess of 15 to 30, in excess of 30 to 45, in excess of 45 to 75 and exceeding that quantum of land being highest slab. The rate of tax has been made progressive. The tax on 15 bighas, 30 bighas, 45 bighas, 75 bighas and 100 bighas of land will be Tk. 51, Tk. 231, Tk. 531, Tk. 1,421 and Tk. 2,641 respectively. This new rate is expected to yield Tk. 49 crores. Revenue collection from land development tax would be around Tk. 45 crores. The introduction of this new meaure will usher in a new horizon which, I am sure, would lead to gradual development in the agriculture sector and increased savings therefrom.

TURNOVER TAX

30. People frequently talk about value-added tax. This tax is very reasonable and progressive. But its administration is rather complex. Particularly in our socio-economic context, it is difficult to introduce the system of value-added tax. Hence, we have introduced a new tax called the Turnover Tax. The application of this tax will be easy and, to begin with, it will cover a limited number of goods and services. It will be realised from specified big establishments. And it will extend to both manufactured goods and sales of goods. It will be imposed on such goods and services which are exempt from excise duty. This tax is leviable only on those individuals or establishments who are income-tax assessees or where the capital investment exceeds Taka 1 lakh. After the initial experiment, this tax will be levied on the basis of capacity. We want to impose this tax initially on four types of establishments, namely: workshops, sweetmeat, manufacturers and dealers, printing industries and dock-yards. To start with, this tax will be limited to establishments in the big towns. We hope to get a total revenue of Taka 5 crores from this source. I believe that in the near future, this tax will emerge as a popular tax resource and all the manufacturing and selling concerns of the country will contribute to increase the domestic savings, through this tax.

31. In determination of the size of the Annual Development Programme we have adopted a very conservative approach this year. This is due to severe strain on our balance of payments position. Restraint has also been exercised in non-development expenditure. Attention has been given to estimation of non-tax receipts on an objective and rational basis. Care has been taken in projection of foreign aid disbursement. Our taxation system is such that its quantum is substantially dependent on external aid and foreign exchange earnings. In spite of these constraints we have estimated tax receipt of Taka 117 crores from new measures out of which about 50 crores are expected from imports on account of customs duty and sales tax.

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CUMULATIVE INDEX 1982 - Nos. 1 – 10

I. ARTICLES

IFA NEWS

DUTCH BRANCH

On 23 October 1982 the Dutch Branch of IFA held its Annual Meeting. After the normal proceedings – Prof. J. van Hoorn was reelected as honorary treasurer – the reports for the 1983 IFA Congress in Venice were discussed. The reporter on Subject I (Tax avoidance/tax evasion) is Prof. A. Nooteboom and the reporter on Subject II (International problems in the field of turnover taxation) is Mr. A.C. Simons. The time available for the discussion proved to be too short as a result of the overwhelming interest shown for the subjects, in particular the first one. The possibility of organizing a second meeting will be investigated.

HONG KONG BRANCH

The Hong Kong Branch of IFA reports that during 1982 a number of meetings were held during which topics of special interest were discussed.
On 8 March members were invited for an evening meeting dedicated to a discussion of income taxation in the People's Republic of China. Three subjects were presented: (i) the special zones, (ii) joint ventures and (iii) ordinary offices in the People's Republic.
On 3 May a meeting was dedicated to the current tax treatment of financial institutions (speaker Mr. David Flux).
The subject of the meeting of 5 July was the taxation aspects of overseas investment in Canada.
The Third Annual General Meeting was held on 18 October 1982 during which, among other things, the Accounts were considered and the Executive Committee was elected. After the proceedings, Mr. Rufus von Thulen Roades, Member of the California and New York Bars, spoke on certain aspects of U.S. taxation.

SWISS BRANCH

The Swiss Branch of IFA announces that it will held a special meeting on 5 November 1982 at which the 1982 IFA Congress in Montreal will be discussed. Dr. A.R. Schmid will report on the first subject (The tax treatment of interest in international economic transactions) and Maître J.M. Rivier on the second (Taxation of payments to non-residents for independent personal services).
The meeting will further be devoted to a discussion of the reports prepared for the 1983 Congress in Venice, i.e. Tax avoidance/tax evasion (Prof. Dr. F. Zuppinger) and International problems in the field of turnover taxation (Dr. W. Haring).
Maître J. Béguelin will speak on some recent developments in French-Swiss relations with respect to international double taxation.

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INHALTSVERZEICHNIS

SOMMAIRE

SINGAPORE

Asian Pacific Tax and Investment Research Centre

A significant event has taken place in Singapore which will contribute to a balanced development in South-East Asia and the Australian and Pacific region.

On 12 November 1982,the *Asian Pacific Tax and Investment Research Centre* was incorporated as a legal charity under the laws of the Republic of Singapore, with headquarters at No. 2, Nassim Road, Singapore 1025, opposite the end of Orchard Road.

The concept emanated from the four seminars on Foreign Investment and Tax Administration held in Manila (1974), Tokyo (1976), Sydney (1978) and Bangalore, India (1980), which were hosted by the countries where they were held and chaired by the Bureau's Chief Executive. They were attended by the heads of Tax Departments and Investment Boards from the countries in the region.

There were two important recommendations at the seminars. As a result of the first, the International Bureau at Amsterdam launched a major effort on behalf of the region by producing an eight-volume loose-leaf publication entitled *Taxes and Investment in Asia and the Pacific,* which is now available commercially and is regularly updated. It is the only service of its kind covering all taxation in the area of Asia and the Pacific.

The second recommendation was for the formation, within the region of Asia and the Pacific, of an institution similar to the International Bureau of Fiscal Documentation at Amsterdam. The centre should be an entirely independent charity modelled after the Bureau in Amsterdam, and sponsored and assisted by it so as to benefit from the Bureau's 45 years' experience. The centre should, in particular, deal with the tax aspects of economic development in the Asian-Pacific countries.

The first discussions were held as early as 1978 with representatives of governments and the business and professional communities in the region. These discussions resulted in a well-defined project which was submitted to the Bureau's Board of Trustees for their approval of the Bureau's sponsorship. In its annual meeting held on 7 May 1981, the Board approved the project and agreed to give any assistance necessary in setting up the Centre in Singapore and to help it in its formative period by providing technical and professional assistance.

A founding committee met in Singapore during the week of 16 November 1981 to work out the details. Members of this committee were:

(1) Professor J. van Hoorn, Jr., Chief Executive, International Bureau of Fiscal Documentation, Chairman;
(2) S. Ambalavaner**, Attorney-at-law, Colombo;
(3) Alun G. Davies*, CBE, Trustee of the Bureau, London;
(4) Graeme L. Herring**, FCA, of Peat, Marwick, Mitchell & Co., Sydney;
(5) N.M. Qureshi**, Executive Director, Asian Development Bank, Manila;
(6) Sidney C. Rolt**, Financial Consultant, Singapore; and
(7) Angel Q. Yoingco**, Executive Director, National Tax Research Center, Manila.

* Trustee of the Bureau.
** Member of the Bureau's Advisory Council.

Objects of the Centre

According to the Memorandum and Articles of Association, the objects of the Centre are:

- to carry on and promote systematic studies relating to tax and investment particularly in the countries of the Asian and Pacific Region;
- to provide training programmes in tax law and administration and tax and investment policies;
- to carry out surveys, provide information, and submit reports and recommendations to governments and the private sector on tax and investment matters which are relevant to the socio-economic development of countries in the Asian and Pacific Region;
- to sponsor and conduct conferences, seminars, group studies, public lectures and courses on tax and investment matters of particular interest for countries of the Asian and Pacific Region;
- to carry on any other activity which may seem to the Centre capable of being usefully and conveniently pursued for the purpose of promoting the above objects.

How the Centre operates, and for whom

The Centre will be equipped to collect, analyse and publish up to date information on taxation and investment matters relating primarily to the countries of the region and, where necessary, to other parts of the world. This will be of assistance and importance to:
- governments,
- business firms,
- banks and financial institutions,
- firms interested in investment in the Asian and Pacific Region, and
- professional firms of lawyers, accountants, tax and investment consultants.

The Centre will have a specialised team of researchers and correspondents and keep members informed of developments on important current problems of tax, fiscal policy and investment pertaining to international trade and investment.

A register of experts will be maintained at the Centre.

Persons interested in helping the Centre as correspondents, researchers and experts are invited to send their names, addresses and bio-data.

Seminars and training programmes

Seminars and training programmes will be organised in the region where government and business representatives are given the opportunity to discuss crucial problems with oustanding experts. Suggestions for topics of discussion from members will be particularly considered.

Research programmes

Research programmes will focus on those aspects of taxation and investment that are of particular interest to the countries in the region and to those engaged in international trade and investment involving these countries and the region as a whole. Special attention will be given to such areas as:

- tax incentive rules and policies in relation to investment flows and the transfer of technology; through its publications – see below – these will be made known to all members
- the research will continuously focus on the effect of measures in developed countries on tax and investment policies in the Asian and Pacific region
- special attention will be given to the question of tax compliance and the effect of high effective tax burdens resulting from high rates or broad tax bases
- aspects of harmonisation of tax legislation and procedures which will ease international trade and investment, particularly in the area of transfer pricing
- the role of tax treaties in encouraging investment flows to the Asian-Pacific region
- the crucial problem of alieviating double taxation and double economic tax burdens in the case of cross-border transactions

Information service

There will be a tax and investment information service to supply members with specific information needed. This information will be made available by the professional staff at the Centre. Where necessary, this service will be rendered in close cooperation with the International Bureau of Fiscal Documentation in Amsterdam. Personal discussion at the Centre will also be possible by prior appointment. Questions may be asked by letter, telephone or telex.

Library

The Centre's library will be open to all members at no extra cost. Members are entitled to request the library staff for information and assistance in tracing materials relating to taxation and investment.

Publications

Apart from other publications the Centre will publish:
(a) The Asian Pacific Tax & Investment News Service
(b) Asian Pacific Tax & Investment Bulletin
These will be sent free to all members.

Board of Governors

The Centre's first Board of Governors is composed of:

Chairman
Prof. J. van Hoorn Jr.,

Honorary Treasurer
Sidney C. Rolt

Chief Executive
S. Ambalavaner

Members
Graeme L. Herring
N.M. Qureshi
Angel Q. Yoingco

and will shortly be joined by
Alun G. Davies, C.B.E.
Raymond E. Moore, Solicitor and Notary Public, Director of Jardine, Matheson & Co., Hong Kong.
Sutadi Sukarya, Chairman of the Capital Market Executive Agency, Jakarta, Indonesia.

Subscribers – Constitutional Members

The following have subscribed to the Centre's Memorandum and Articles of Association:

J. van Hoorn Jr.	Amsterdam
S. Ambalavaner	Sri Lanka
Alun G. Davies	United Kingdom
Graeme L. Herring	Australia
N.M. Qureshi	Philippines
Sidney C. Rolt	Singapore
Angel Q. Yoingco	Philippines
Adiya Vikram Birla	India
Arvind N. Lalbhai	India
Sutadi Sukarya	Indonesia
Benjamin Abela	Philippines
Raymond E. Moore	Hong Kong

It is intended to increase the Constitutional Members to fifty, and to include amongst them members of the judiciary, the tax administrations, major industrial and commercial organisations, and the universities in the region.

Contributions

The Centre will be glad to receive donations of books, journals and other material on tax, fiscal policy and investment. Authors and publishers of books, periodicals and journals on the above subjects are invited to send one copy of each publication to the library and for indexing and review in the Bulletin.

The Government of Singapore has already assisted the Centre by making available premises at No. 2, Nassim Road, Singapore for a nominal rent. Several Governments, as well as professional firms and corporations in the area of banking, industry and commerce, both in the region and elsewhere, have already contributed considerable sums to the Centre in order to enable it to commence its operations as soon as possible.

Subscriptions – Membership

The subscriptions for the Centre for its publications and other facilities are as follows:

(a) FOUNDING-PATRON MEMBERS – US$ 30,000 payable in instalments of US$ 10,000 in the years 1983, 1984 and 1985, the first payment to be made forthwith. Founding-Patron Members will be entitled to one copy each of all publications of the Centre, and the right to information and answers to questions. An additional set of publications will be supplied on request without charge. This facility will be available for the year 1983 and all subsequent years.

(b) FOUNDING MEMBERS – subscription of US$ 15,000 to be paid now. Members will be entitled to one copy each of all publications of the Centre for 25 years and the right to information and answers to questions. An additional set of publications will be supplied on request without charge. At the end of 25 years the Governors may continue these facilities taking into account the then current costs.

(c) ASSOCIATE MEMBERS – subscription of US$ 7,500 to be paid now. Members will be entitled to one copy of the Centre's publications and the right to information and answers to questions for a period of 15 years. At the end of 15 years the Board of Governors may extend these facilities taking into account the then current costs.

(d) CORPORATE MEMBERS – membership will be US$ 250 per year. This membership will be open to corporations, institutions and firms. Corporate Members will be entitled to a copy of each of the publications for the year.

(e) INDIVIDUAL MEMBERS – membership will be US$ 60 per year. Such members are entitled to one copy of the publications of the year.

THE CENTRE SEEKS FINANCIAL AND OTHER ASSISTANCE FROM GOVERNMENTS, INSTITUTIONS, CORPORATIONS AND INDIVIDUALS TO ESTABLISH AND MAINTAIN THE CENTRE.

Personal Income Taxation and Equity in India

by P.K. Bhargava and A.K. Jain *

Progressivity is an essential feature of a modern tax system. It is essential for two reasons: to reduce inequalities in the distribution of wealth and income and to ensure built-in-flexibility in the tax structure. There are two aspects of progressivity: equal treatment of equals (horizontal equity) and unequal treatment of unequals (vertical equity). The object of this paper is to examine the extent to which personal income tax in India fulfills the criteria of horizontal and vertical equity.

HORIZONTAL EQUITY

There is equal treatment of equals with respect to personal income tax in India in so far as a system of "global" tax rates and not "schedular" tax rates is followed. However, there are some important features of the personal income tax structure where this criterion is violated. Exemption of casual and non-recurring income from the tax base is a glaring example of such an anomaly. Prior to the amendment made in 1972, receipts which were of a casual and non-recurring nature were exempt from tax except where the receipts constituted capital gains or arose from a business or the exercise of a profession, vocation or occupation or were by way of additions to the remuneration of an employee. Consequently, a number of receipts which resulted in increased wealth of the taxpayer were excluded from the tax net. The tax base also did not embrace receipts like punitive damages (though not amounting to recovery of capital), found property or accidental receipts, amounts received by way of lottery, crossword puzzles, races, or of embezzlement, blackmail, extortion and other criminal activity.[1] Winnings from State or other lotteries in the case of non-corporate taxpayers were subjected to tax by the Finance Act, 1972. However, casual and non-recurring receipts up to 1000 Rs. were exempt from the tax base and this provision continues to date. There appears to be no justification for such an exemption. Equity considerations demand that all accretions to personal income or wealth should be included in the tax base.[2] It may also be emphasized that the inclusion of recurring receipts in the tax base is not only wrong in principle but also leaves much to the discretion of tax administration and law courts to decide which receipts are occasional and which are regular.[3] In this context, a number of conflict decisions can be seen in India. "Thus, where the taxpayer received an annual allowance payable solely in the discretion of the taxpayer, the receipt was held to be non-recurring even though paid regularly over the period of a number of years. . . On the other hand, where a retired judge agreed to arbitrate a dispute for a fixed fee, the fee was held to be taxable."[4]

The criterion of horizontal equity is also violated in view of the fact that agricultural income is not taxed at all under the Central income tax. The anomaly has been partly rectified by the scheme of "partial integration" introduced by the Finance Act, 1973. Under this scheme, the agricultural income of a taxpayer is considered only to determine the rate of tax on his non-agricultural income and agricultural income still goes untaxed. The only advantage of this reform is that if a taxpayer has both agricultural and non-agricultural income, the latter attracts a higher rate of tax. However, it would still be advantageous for non-agriculturists to show a part of their income originating in the agricultural sector because it is only at the margin that assessees with similar aggregate income are taxed similarly.[5] Further, agricultural income is considered only to determine the rate on non-agricultural income if non-agricultural income exceeds the exemption limit. It may be emphasized here that under the Indian Constitution the State Governments are empowered to levy agricultural income tax. However, all the State Governments, even the richer States like Punjab and Haryana, have not exercised this power.[6] Also, in States where agricultural income is taxed, the tax rates are so varied that one is included to conclude that income taxation in general and agricultural income tax in particular do not fulfill the equity criterion.

VERTICAL EQUITY

Capital accumulation is a growing necessity of developing economies like India. With increasing capital accumulation, marked inequalities in the distribution of wealth and income also develop. However, in a welfare state inequalities in the distribution of wealth and income are neither desirable nor can they be tolerated for long. It is, therefore, necessary that people with higher incomes should not only pay more tax but they should also pay tax at a higher rate so that vertical equity is achieved. This necessitates a progressive rate structure on a "slab system" basis.

India always had the distinction of having a schedule of progressive income tax rates. However, from an equity point of view what is important is the effective tax rate and not the statutory tax rate. With the increase in schedular progressivity, the average income tax burden for all income tax payers should have shown a consistent increase but the available data clearly indicate that the average burden has generally shown a decline.

---

* Readers in Economics, Banaras Hindu Univerity, Varansi.

1. V.V. Borkar, *Income Tax Reform in India,* 1971, p. 91.
2. Anil Kumar Jain, "The Concept of Income under the Indian Income Tax", *Public Finance/Finances Publiques,* Vol. 30, No. 1, 1975, p. 88.
3. Anil Kumar Jain, *Taxation of Income in India,* 1975, p. 17.
4. World Tax Series (WTS), *Taxation in India,* 1960, p.229.
5. P.K. Bhargava, "The Raj Committee Report – A Comment on Agricultural Tax Reform Problems in India", *Public Finance/Finances Publiques,* Vol. 29, No. 2, 1974, p. 205.
6. For details see, P.K. Bhargava, *Taxation of Agriculture in India,* 1976, pp. 33-47.

TABLE 1

Tax demanded under personal taxation *

Year	Total assessed income	Total tax demanded	Average tax rate (3 as % of 2)
(1)	(2)	(3)	(4)
1951-52	582.9	103.9	17.8
1956-57	647.8	106.5	16.4
1961-62	1024.3	136.5	13.3
1966-67	1605.6	226.0	14.1
1971-72	2567.2	432.7	16.8
1972-73	2220.8	357.6	16.1
1974-75	2534.4	405.0	16.0
1975-76	2742.8	426.3	15.5
1976-77	3066.0	507.0	16.6
1977-78	3405.4	540.1	15.9
1978-79	2930.6	499.5	17.0

* Personal taxation includes tax on individuals, Hindu undivided families, unregistered firms, associations of persons and others and thus excludes tax on registered firms and companies. 1 crore = 10,000,000.

It is clear from Table 1 that the average income tax rate (ratio of total tax demanded to total income assessed) declined from 17.8% in 1951-52 to 13.3% in 1961-62. Thereafter, it increased to 16.8% in 1971-72 but declined again to 16.0% in 1974-75 which was still lower than the average rate of tax for 1951-52. These findings are in sharp contrast to the fact that there has been a tendency to increase the statutory marginal tax rates over the period: the highest marginal tax rate (including surcharge) during the assessment year 1974-75 was as high as 97.7% on slabs of income exceeding 200,000 Rs. whereas in 1951-52 it was 82.3% on incomes exceeding 150,000 Rs. On recommendation of the Wanchoo Committee, the highest rate of income tax (including surcharge) was reduced to 77% by the Finance Act, 1975 and further to 66% by the Finance Act, 1976. In subsequent years, the marginal rate of income tax continues to be 60% but there have been changes in the surcharge on income tax which was reduced from 20% to 10% by the Finance (No. 2) Act, 1980. It may also be noted that the increase in the average tax rate to 17% in 1978-79 is indicative of the fact that more income was taxed in the higher income slabs.

That vertical equity among different income tax payers is not achieved is also clear from the fact that the effective income tax rates for different income groups are much lower than the corresponding statutory tax rates. Table 2 presents the available data on the effective rates of income tax for each income class for selected years. It is clear from the table that the effective tax rate for income tax payers with taxable income exceeding 70,000 Rs. declined during the period 1951-52 to 1978-79. For the income slab of 70,001-100,000 Rs., it declined from 46.0% to 44.4% and for taxable income of 100,001-200,000 Rs., the corresponding rate declined from 59.0% to 54.7% during the same period. For incomes exceeding 200,000 Rs., there has been a greater decline from 73.4% to 69.0%. The existence of very high rates on the statutes over a considerable period can possibly be explained in terms of increasing tax evasion and avoidance, increase in the number of tax incentives which benefit mostly the people in relatively higher income brackets and inefficient tax administration. The advantages of tax evasion in India have been enormous. For example, when the highest marginal tax rate was 97.7% during the assessment year 1974-1975, the net profit on concealment was as high as 4,300% of after-tax income.

TABLE 2

Income assessed and tax demand in different income ranges for individuals
(Crores of Rs.)

Grades of income	1951-52			1961-62			1971-72			1978-79		
	Income assessed	Total tax	3 as % of 2	Income assessed	Total tax	6 as % of 5	Income assessed	Total tax	9 as % of 8	Income assessed	Total tax	12 as % of 11
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
Below 5,000	94.3	2.4	2.5	143.7	1.3	0.9	86.7	1.2	1.4	2.6	0.3	11.5
5,001 – 10,000	128.8	6.2	4.8	241.0	6.6	2.7	566.1	27.5	4.8	206.9	7.9	3.8
10,001 – 15,000	59.9	5.2	8.7	127.3	7.4	5.8	429.7	33.8	7.9	828.3	56.9	6.9
15,001 – 25,000	56.7	8.0	14.1	133.3	13.5	10.1	465.8	54.4	8.6	766.4	84.6	11.0
25,001 – 50,000	57.4	15.2	26.5	127.4	28.3	22.2	357.9	88.0	24.6	578.1	125.4	21.7
50,001 – 70,000	18.8	6.3	33.5	36.6	13.2	36.1	96.3	36.4	37.8	122.5	41.0	33.5
70,001 – 100,000	15.2	7.0	46.0	26.8	12.1	45.1	68.8	31.3	45.5	81.6	36.2	44.4
100,001 – 200,000	18.8	11.1	59.0	28.3	16.1	56.9	71.0	39.5	55.6	68.6	37.5	54.7
Over 200,000	25.6	18.8	73.4	20.1	13.9	69.1	69.5	45.7	65.7	70.7	48.8	69.0

The variation between the statutory tax rates and the effective tax rates can also be partially explained by the increasingly larger tax reliefs which have been provided in the Indian Income-tax Act. With the passage of time, the number of incentives, and the number of taxpayers taking advantage of those incentives, has increased. This is clearly borne out by the fact that total deductions as also the ratio of total deductions to total income assessed have increased over the period as is clear from Table 3.

TABLE 3

Ratio of total deductions * to total income assessed
(Crores of Rs.)

Year	Total deductions	Total income assessed	2 as % of 3
(1)	(2)	(3)	(4)
1953-54	36.8	781.0	4.7
1956-57	48.8	936.7	5.2
1961-62	132.6	1575.4	8.4
1966-67	160.3	2532.2	6.3
1971-72	252.5	4389.8	5.7
1972-73	216.6	3611.8	6.0
1974-75	257.5	4120.6	6.2
1975-76	288.3	4706.2	6.1
1976-77	376.6	5266.1	7.1
1977-78	424.0	5862.8	7.2

* Includes rebates and double income tax relief, as well.

Table 3 shows that there has been a phenomenal increase in the quantum of total deductions during the period 1953-54 (Rs. 36.8 crores) to 1977-78 (Rs. 424.0 crores). During the same period, the ratio of total deductions to total income assessed also increased from 4.7% to 7.2%, except for the year 1961-62 when the corresponding percentage was 8.4. This is perhaps because of the fact that the total assessed income increased at a relatively slower rate as compared to the increase in the rate of total deductions during the period 1956-57 to 1961-62. The Indian income tax incorporates a number of tax incentives to encourage savings, investment, exports, etc. Two forms of incentives have been offered. Certain types of income and investments have been totally excluded from the purview of taxation such as interest received on deposits in the post-office savings bank, interest on post office National Savings Certificates, National Defence Certificates, etc. On the other hand, certain types of income on specified investments are either exempt to a certain extent or they are deducted from taxable income while computing total income, such as contributions towards provident funds, life insurance premia, public provident funds, 10 or 15-year Cumulative Time Deposit Schemes, Unit linked insurance plans, etc. Similarly, 50% of the investment in the shares of new companies may also be deducted. Income from certain categories of investments such as dividends from companies, interest on bank deposits, etc. is exempt up to 3,000 Rs. per annum (increased to 4,000 Rs. in the Union Budget for 1982-83). Further, income from Units of the Unit Trust of India is exclusively exempted up to 2,000 Rs. (raised to 3,000 Rs. in the Union Budget for 1982-83). Incentives have also been granted to promote agriculture, exports, particular industries or areas.[7] Prior to the assessment year 1968-69, these incentives were generally granted in the form of rebates from income tax but from the assessment year 1968-69 most of them have taken the form of deductions from total income. These incentives have reduced the tax burden to a great extent, and have mostly benefitted the high income group people as their capacity to save is greater and the tax advantage to them is also greater. As we have a progressive rate structure in India and incentives take the form of deductions from total income, the taxpayer gests the benefit at the rate of tax applicable to the highest slab of income. The gross rate of return depends upon the slab of income in which an assessee falls. The gross rate of return is as high as 37.1% for Units, 38.7% for 6-year National Savings Certificates and 32.3% for fixed deposits with banks. Even in the case of savings deposits with post offices where the rate of interest is only 5.5% per annum, the gross rate of return is as high as 17.7% for incomes above 100,000 Rs. and it is profitable for a taxpayer with an annual income of more than 30,000 Rs. to keep his money in the post office savings bank rather than to deposit it in banks and earn 10% interest.[8] These tax concessions have made the effective tax rates much different from the statutory rates and the pity is that "the differential operates regressively in favour of the high income groups as against low income groups".[9]

Finally, a word must be said about the changes in the rate and quantum of the standard deduction available to salaried taxpayers and the exemption limit. The provision of the standard deduction at the rate of 20% of the salary up to 10,000 Rs. and 10% of the salary in excess thereof, subject to a maximum deduction of 3,500 Rs., was introduced by the Finance Act, 1974. The Finance Act, 1981 made the rate of standard deduction uniform at 20% and also raised the monetary limit to 5,000 Rs. The Union Budget for 1982-83 has increased the rate to 25% without a change in the maximum monetary limit for standard deduction. There has also been a tendency to increase the exemption limit of income tax: from 4,000 Rs. to 5,000 Rs. from the assessment year 1971-72, to 6,000 Rs. by the Finance Act, 1974, to 8,000 Rs. by the Finance (Amendment) Act, 1975, to 10,000 Rs. by the Finance Act, 1977, to 12,000 Rs. by the Finance Act, 1980 and to 15,000 Rs. by the Finance Act, 1981. The successive increases in the exemption limit have increased the operative limit which at present ranges from 25,000 Rs. to 30,000 Rs. This has not only reduced the effective rate of income tax but also the number of income tax assessees.

CONCLUSION

The above discussion amply demonstrates that the personal income tax structure in India has been designed to achieve both horizontal and vertical equity. In practice, it does not fully achieve either of the two, although horizontal equity is achieved to a relatively larger extent. There are mainly two grounds on which the criterion of

7. For details see, Anil Kumar Jain, *Taxation of Income in India*, 1975, Chapter 6.
8. Provided the income from bank deposits, dividends, etc. exceeds 3,000 Rs. in a year.
9. I.S. Gulati, "Growth Oriented Budget: An Analysis of Major Suggestions", *Economic and Political Weekly*, March 1976, p. 419.

horizontal equity falls: firstly, favourable treatment is accorded to causal and non-recurring incomes, and secondly, agricultural incomes are excluded from the Central income tax base.

The personal income tax structure also does not adequately satisfy the effective requirements of unequal treatment of unequals mainly due to four reasons: firstly, the discrepancy between the effective tax rates and statutory marginal tax rates has been found to be increasing with increased levels of income. Secondly, tax evasion has increased as the income tax rates have gone up. Thirdly, relatively richer persons have been taking more and more advantage of various tax concessions and incentives, thus bringing down the effective tax rate. Fourthly, a number of administrative problems such as arrears of assessment and collection, pendency of appeals, delays in granting refunds and strained public relations, etc. have further reduced the effectiveness of income tax as an equity measure.

IFA NEWS

Montreal Congress 1982

Results of the Discussions

At the end of the Montreal Congress of IFA (12-17 September 1982) the following resolutions were adopted. Note that they were originally drafted in the German and French languages, respectively. We reproduce here the approved English translations.

SUBJECT I:

The tax treatment of interest in international economic transactions

RESOLUTION (German original)

Whereas:

a) The avoidance of double taxation in the international flow of capital is in the interest of all countries and their taxpayers.
b) Both the debtor's and the creditor's country of residence should make a reasonable contribution towards the avoidance of double taxation and the reduction of the total burden of taxes.
c) There should be no discrimination between international and national movement of capital.
d) The rules on interest in the OECD model agreement of 1977 have not yet been incorporated into all double taxation agreements and that these solutions should be further developed.

Now IFA proposes:

1. Arm's length interest paid to non-resident creditors should be a deductible expense in the same way as domestic interest paid in the debtor's country.
2. Insofar as the debtor's country wishes to assess tax, this should not be effected by way of disallowing the interest expense, but instead by levying a non-resident withholding tax.
3. The deduction of interest to non arm's length persons should only be disallowed to the extent that the conditions and the rate of interest are obviously in excess of the going market rate or normal market conditions. Individual cases should be decided on a case by case basis after taking all circumstances into consideration. Fixed ratios of debt to capital and the incidental normal interest rates should not be laid down, but should only have the character of a "safe havens" clause.
   The double taxation agreements ("DTC") should contain a clause which provides that interest disallowed as being in excess of normal market conditions, and therefore treated as a dividend in the debtor's country, should also be treated as a dividend in the creditor's country. It should be ensured that the creditor will be entitled to the same tax relief as would be applicable to intercorporate dividends under domestic legislation or the respective DTC.
4. Insofar as the payor or debtor country assesses non-resident tax on the interest paid abroad, it should be considered that the creditor has usually considerable refinancing and other expenses. This should be effected by unilaterally providing for a low rate of non-resident withholding tax.
   In the case of interest received from a foreign country the double taxation should be avoided in the creditor's country through unilateral measures providing tax credits or exemptions. The mere deduction of the foreign tax from income does not give sufficient relief. In cases where the tax credit method is used for foreign non-resident withholding tax, full credit for the taxes deducted should be allowed. This requires that if the creditor country grants credit on the net income basis only the expenses directly connected with the interest are taken into account and that the overall limitation is applied. Furthermore, the excess of foreign non-resident tax levied over the applicable tax in the creditor's country (excess credits) should be allowed to be carried forward or back to prior periods or should be allowed in some other way.
5. In cases where the contracting states of DTC are not prepared to allow for the total exemption from non-resident withholding tax, both the debtor's and creditor's country should make a reasonable contribution towards the avoidance of double taxation and the total incidence of taxation.
   On the one hand, the debtor's country should provide for a low rate of non-resident withholding tax, on the other hand the creditor's country should allow the credit of the remaining non-resident withholding tax against its own tax liability or exempt the interest from taxation. As to the measures to fully avoid double taxation in the creditor's country see paragraph 4 above.
   It could be in the interest of the contracting states and their taxpayers in order to encourage investments in

the developing countries that the creditor's country allows a tax sparing credit.

6. Where a double taxation agreement provides for a reduction of the withholding tax on interest, this reduction should be effective on payment immediately and should not only be granted in a subsequent refund procedure.
Where a permanent establishment is subject to tax in a country which has a double taxation agreement, the agreement should provide that such permanent establishment can claim the limitation of non-resident withholding tax and the tax credit provided in the agreement between the source country and the country in which the permanent establishment is located.
7. The problem of the taxation of interest income which contains to a considerable extent a compensation for losses caused by inflation should become the subject of a special study.

SUBJECT II:

Taxation of payments to non-residents for independent personal services

RESOLUTION (original version: French)

1. Considering:
1.1. That the free flow of, and access to, professional, technical, cultural, and athletic skills and information is conducive to the promotion of the social and economic well-being of all people, particularly in the context of the rendering of independent personal services by non-residents;
1.2. That in today's world trade and business environment it is becoming more and more difficult to distinguish between income from the sale of goods and information and income from the rendering of independent personal services, especially since such income may be derived both by individuals and by companies;
1.3. That conflicting rules determining the source of income from independent personal services exist among countries, and that furthermore it is increasingly difficult to determine where the services giving rise to the income are performed or utilised;
1.4. That taxation by a country of the income of a non-resident person from such services without a clear and sufficiently strong economic connection with that country entails a serious risk of double taxation; and
1.5. That taxation of the income from such services on a gross basis is in conflict with the generally accepted principles of income taxation and may result in an arbitrary and excessive tax burden;

2. Recommends:
2.1. That domestic legislation adopt a rule subjecting non-residents performing independent personal services to taxation only if such services are performed in that country in spite of difficulties of practical application;
2.2. That bilateral double taxation conventions be concluded in order to further promote the free flow of, and access to, professional, technical, cultural, and athletic skills and information and that to that end such conventions limit wherever possible the right to tax of the country where the services are performed by a non-resident in cases where
(i) there is a fixed base in that country; or
(ii) the person performing the services stays in that country for more than a minimum period of time;
(iii) the income derived from such services exceeds a minimum threshold;
it being understood that said period of time and/or threshold shall be fixed in each convention by negotiation and mutual agreement between the signatories of the convention;
2.3. That, if a withholding tax is levied on the gross income of a non-resident from independent personal services, the rate of such tax or the determination of the taxable base should recognize that usually substantial direct and indirect expenses have been incurred in producing such income;
2.4. That in double taxation conventions, the non-resident who is subject to tax on income from independent personal services should be given the right to be taxed on the basis of net income by filing a return and establishing evidence of deductible expenses in a manner at least as favourable as that which would apply under the convention to non-resident persons earning business profits;
2.5. That if, in the negotiation of a double taxation convention, it becomes apparent that the two countries have a different understanding of the term "income from independent activities", the convention or a protocol thereto should attempt to define that term and distinguish it from other terms used in the convention that may overlap it, such as "profits of an enterprise", "remuneration from employment", "royalties", etc.
In particular, the contracting states should make it clear whether they intend the article dealing with income from independent activities to apply to companies;
2.6. That the article in the double taxation convention dealing with the income from independent personal services should contain provisions to indicate the priority of application in cases where an item of income is also covered by another article;
2.7. That, although in double taxation conventions the inclusion of separate rules dealing with artists and athletes is justified, the recommendations outlined above should be made equally applicable to artists and athletes;
2.8. That in domestic law and in double taxation conventions, consideration be given to applying to non-resident artists and athletes measures mitigating the unduly harsh effects of progressive tax rates in cases of very irregular income, if similar measures apply to residents; and
2.9. That in double taxation conventions, the application of articles giving the countries the right to tax the income derived by a non-resident person other than the performer, from the performance of personal services by an artist or athlete, be restricted to situations where the performer and the other person are not dealing at arm's length.

[continued on page 559]

NEW ZEALAND BUDGET 1982:

Tax Proposals

By Dr. M.P. Dominic

The Budget presented by the Minister of Finance, the Rt. Hon. R.D. Muldoon, on 5 August 1982 contains a number of proposals relating to personal income tax, tax avoidance, life assurance, superannuation, and building societies.

The scope of the tax proposals is limited by the overriding priority of reducing inflation. These proposals incorporate some of the changes proposed by the Task Force on Tax Reform which was established after the last Budget to examine the system of Central Government taxation, both direct and indirect. In the time available, the Task Force identified the areas of most immediate concern and suggested options for reform. Further study was proposed for other areas such as inflation adjustment of business income and taxation cooperation. The areas suggested for immediate reform include personal income tax and indirect consumption taxes.

Personal income tax

The objectives of the proposed changes are:

- first, to lessen substantially the fiscal drag in the present scale. Fiscal drag is the phenomenon by which, under a progressive tax scale and rising nominal incomes, tax paid rises faster than the growth in those incomes. Its effect is to erode disposable incomes and destabilise the economy;
- the second objective is to minimise the disincentive impact of high marginal tax rates on work, savings, and investment decisions;
- the third objective is to minimise the incentive for tax evasion and avoidance caused by high marginal tax rates;
- the fourth objective is to reduce the imbalance between the tax paid by single-income families and two-income families with the same total income;
- the fifth objective is to reduce the difference in the tax burden between taxpayers with steady incomes and those with fluctuating incomes.

(a) Housekeeper rebate

The present housekeeper rebate will be retained and increased, from 1 October 1982, in recognition of the additonal costs of child care incurred by two-income families, especially those with pre-school children. The maximum rebate will be increased from $156 to $310 a year, at a rate of 31 cents in the dollar on qualifying expenditure up to a maximum of $1,000 a year. This rebate will be available only on an end-of-year basis.

(b) Child rebate

The present rebate is $78. From 1 October 1982, it will be increased to $156. Assuming the marginal tax rate is 20%, the increased rebate will be equivalent to tax-free savings of $780 in a full year, compared with $538 at present. This rebate was introduced in 1978 to avoid the need for pre-school and school children to pay tax on small amounts of income.

(c) The overtime, shiftwork and back pay rebates

These rebates will be abolished from 1 October 1982 as a consequence of introducing a reduced income tax scale structure. They were originally introduced to minimise the effect of the present steeply progressive tax scale.

(d) First-home mortgage interest rebate

The rebate rate will be reduced from 1 October 1982 from 50% to 31% of qualifying interest, reflecting the new standard marginal tax rate of 31% for most taxpayers. This would mean that the maximum amount of qualifying interest will be increased from $2,000 to $3,225 in a full year.

The maximum level of the rebate will continue to be $1,000 a year.

(e) Dependent relative rebate

The rate of rebate will be, with effect from 1 October 1982, 31% rather than 40%. The maximum level of this rebate will remain $60 a year. The rebate may be claimed only in respect of two dependent relatives.

(f) Charitable donations and school fees rebate

The rate of rebate will be 31% rather than the present 50% of eligible donations and fees, reflecting the new standard tax rate of 31% for most taxpayers. The maximum level of rebate will be increased to $200 a year. This would mean the maximum qualifying expenditure will increase from the present $350 to $645 in a full year.

(g) Home vendor mortgage rebate

This rebate, which was introduced in 1978, will be abolished. Only a small number of taxpayers have claimed this rebate. The rebate will continue to be available to taxpayers holding approvals before 6 August 1982.

(h) Family rebate

A family rebate of $1,404 a year will be given from 1 October 1982 to all families with dependent children and an annual threshhold income of up to $9,800. Where the threshhold income ranges between $9,800 and $19,160 a year, the rebate will abate at the rate of 15 cents in the dollar. This will replace the present low-income family, young family and spouse rebates.

(i) Use of private dwelling in connection with employment

The deduction allowed in the Fourth Schedule to the Income Tax Act for expenditure or losses incurred in the use of a private dwelling in connection with the employment of a taxpayer will be restricted to the additional expenditure incurred in the use of the specified room or defined area for purposes relating to the taxpayer's employment.

(j) Family rebate and principal income earner rebates for persons entering or leaving New Zealand during a year

Where a person enters or leaves New Zealand, the income of that person during that part of the year in which he is resident in New Zealand will be grossed up to its full-year equivalent in order to determine the appropriate level of family and principal income earner rebates.

(k) Superannuation schemes for individuals

In future, superannuation schemes for individuals under Part II of the Superannuation Schemes Act will be approved by the Government Actuary only if at least one of the following criteria is met:

- they provide at least 75% of their benefits in pension form;
- the trustees and contributors are arm's length parties.

Existing schemes not meeting one of the above criteria will be given the option of converting to a pension scheme or winding up without additional tax liability. Alternatively, they may continue without the present tax advantages.

In addition, changes will be announced shortly to reduce the tax advantages arising from the present tax treatment of superannuation schemes for individuals. The Government considers that at present individuals are able to transfer large amounts of cash and capital assets, often the business assets of the contributor, to these schemes but at the same time maintaining effective control of these assets.

(l) Tax rates

From 1 October 1982, the personal income tax rates will be:

Taxable income	Rates
up to $6,000	20%
$ 6,000 – $24,000	31%
$24,000 – $30,000	41%
$30,000 – $38,000	51%
above $38,000	60%

As a result of these changes, the marginal tax rate for approximately 90% of all taxpayers will be 31% or less. The 31% marginal tax rate will apply to over 60% of all taxpayers. At present, they are subject to marginal tax rates ranging up to 60%.

(m) Transitional measures

There will be some transitional problems with the introduction of the new scale, both at the lower and upper ends of the income range. At the lower end, some people who do not qualify for the family rebate would pay more tax as a result of the change in the scale. At the upper end, a small number of taxpayers would receive very large tax cuts. This latter effect is justified to a large extent, given that in recent years the higher tax rate thresholds have been less effectively adjusted for inflation than the lower thresholds.

To minimise these problems and to ensure that virtually all principal income earners receive a tax cut from 1 October 1982, the following two transitional measures will be introduced from 1 October 1982:

(1) Temporary surtax

A temporary surtax of 10% of the marginal tax rates applying to all income above $24,000 will be imposed.

The effect of this temporary surtax on the marginal tax rates will be as follows:

income	*rate*
up to 6,000	20 (unchanged)
6,000 – 24,000	31 (unchanged)
24,000 – 30,000	45.1
30,000 – 38,000	56.1
above 38,000	66

These rates will be reflected in new PAYE tax tables applying to pay periods ending on or after 1 October 1982, and will become the annual rates in respect of income from 1 April 1983. The combined effect of the present and the new tax rates will be taken into account in determining the annual tax rate scale on income earned during the year ending 31 March 1983.

(2) Rebate

A rebate of 5.5% of taxable income, up to a maximum of $312 a year, will be given to all taxpayers – other than children, spouses of principal income earners, national superannuitants – and principal income earners eligible for the new family rebate. The full rebate of $312 will be given to all eligible taxpayers earning between $5,673 and $12,000 a year and it will abate against principal income at 12 cents in the dollar over the income range $12,000 to $14,600 a year.

Leasing

New provisions apply to financial leases entered into after 5 August 1982 placing financial leasing on the same footing for tax purposes as other forms of financing the acquisition of assets. The new provisions are:

- financial institutions will no longer be able to treat financial leases in the same manner as short-term hire contracts for income tax purposes. Instead, they will be required to follow generally accepted accounting practice and record their leasing transactions on the same basis as if they were loans;
- the lessor will be excluded from claiming depreciation allowances on assets subject to financial leases;
- the lessor will be permitted to deduct an amount equivalent to tax depreciation allowances for the particular leased asset, including first-year depreciation allowances if applicable, together with an amount equal to the interest content of lease payments.

No change is made to the existing tax treatment of leases of land and buildings and short-term hire contracts.

Film industry

A new tax regime incorporating the main features of the present tax treatment but without the tax shelters arising from the use of non-recourse loans and other leveraging arrangements will be introduced. But, in recognition of the effect of the change in the tax treatment, the Government will give $1.75 million in 1982-83 to the Film Commission and this grant will be reduced progressively to zero over a period of 5 years.

Farming and property investment

The following anti-avoidance measures were announced and will be implemented in respect of the income year beginning 1 April 1982 or equivalent accounting year:

- under the present provisions, where a farm or fish farm is sold at a profit within 5 years of purchase and deductions have been allowed for development expenditure on the farm, that profit is treated as assessable income up to the extent of the deductions allowed. In order to discourage the purchase and development of farms for capital gain rather than for productive use, the period of farm or fish farm ownership necessary to avoid recovery of the development expenditure deductions will be extended from 5 years to 10 years;
- interest deducted in respect of any land used in the production of income will become assessable for income tax to the extent of profits made on the sale of that land within 10 years of its acquisition;
- new farmers and those purchasing additional land will be required to write down the value of livestock purchased from cost to standard or nil values progressively over a period of 3 years;
- losses created by the writing down of livestock to standard or nil values may in future be written off against farming income, but not against income from other sources;
- the period for determining basic livestock numbers under the nil or standard value scheme will be extended from 2 to 4 years, or such shorter period as the Commissioner of Inland Revenue may determine;
- partnerships and syndicates of more than 6 persons engaged in farming, fish farming, horticultural and property owning ventures will be treated as companies for income tax purposes.

The provisions relating to the recovery of prior year expenditure apply to property sold after 5 August 1982.

Investment allowances

After a comprehensive review of investment allowances granted in New Zealand, the Government is of the view that:

> Experience with these schemes indicates that they are not effective in achieving their original goals, and waste money in subsidising activities that are not intended targets. Frequently their purpose has been fulfilled by broader policy moves or other events. Research, both in New Zealand and overseas, indicates that these incentives have had little impact on firms' investment decisions.

The Government has decided not to extend the following investment allowances after the current expiry date of 31 March 1983:

- the regional investment allowance;
- the export investment allowance;
- the fishing investment allowance.

High priority investment allowance

The high priority activity scheme under the high priority investment allowance will be terminated on 28 October 1983, but no further applications for new approvals or for extensions of high priority status will be accepted after 5 August 1982. The existing approvals will be allowed to run their course.

Industrial development plan investment allowance

The terminating date will be extended to 31 March 1986 to allow the existing commitments to the wine and plastics industries and the New Zealand Steel expansion to be met.

Farming and agricultural investment allowance

It will be extended for a further year to 31 March 1984. Its future will be considered in the next year's budget in the context of overall assistance to farming.

CNG (Compressed natural gas) and LPG conversions

Previously, depreciation could be claimed on the expenditure of CNG or LPG conversions carried out subsequent to the assembly of a motor car acquired by a business but not if such expenditure was incurred in respect of a car converted during assembly or if the cost of the car itself was more than $11,000. With effect from 1 April 1982, depreciation may be claimed on the cost of the assembly-line conversion of a business motor car. The depreciable cost will, however, be limited to the following:

- $1,200 for a one-cylinder CNG conversion;
- $1,600 for a two-cylinder CNG conversion;
- $1,400 for an LPG conversion.

Tax-free dividends

With effect from 1 April 1982, dividends from capital gains will qualify as tax free in the hands of the shareholders only if such gains have been realised through arm's length transactions outside any particular group of companies. "The aim of this measure is to prevent revenue losses arising from artificial arrangements to establish capital profits but which do not generate the cash to fund the resulting tax-free distributions to shareholders."

Charitable companies

From 1 April 1983, business income of charities will be exempt only if the business is directly related to the principal function of the charity concerned, or where the business employs that category of people for whose benefit the charity was originally established.

Life assurance and superannuation funds

From 1 April 1983, the following changes will be made in the tax treatment of life assurance companies and superannuation funds:

- life assurance companies will be taxed on net investment income at a rate of 31% instead of the present 30% of allotted bonuses and dividends;
- lump-sum superannuation funds, which are tax exempt at present, will also be taxed at 31% on net investment income;
- superannuation funds which provide at least 75% of benefits in pension form will remain tax exempt;
- the personal tax exemption limits for life assurance premiums and contributions to superannuation schemes will be increased from $800 to $1,200 for members of employer-subsidised superannuation schemes, and from $1,000 to $1,400 for persons who are not members of subsidised schemes.

Building societies

Commencing with the 1983-84 income year, income of building societies will be taxed at the company rate of 45%. Dividends paid on withdrawable shares will be deductible in arriving at a society's assessable income.

Estate duty

For estates of persons dying on or after 1 April 1983, the exemption will be increased to $350,000.

Bonus issue tax

The bonus issue tax will be abolished. But, with effect from 1 April 1982, where there is a return or reduction of capital within 10 years of bonus issue, that part of the return or reduction which is applicable to the bonus issue will be taxed in the hands of the shareholder. Any return or reduction of capital will be deemed first to be attributed to bonus issues during the preceding 10 years.

Other taxes

Changes have also been announced in respect of stamp duty, taxes on alcoholic beverages and tobacco products, petroleum fuel taxation, international departure tax, and sales tax.

NEW ZEALAND:

Budget 1982

Extracts from the Financial Statement submitted by Mr. R.D. Muldoon, C.H., Prime Minister, to the House of Representatives on 5 August 1982.

See for a detailed discussion of the New Zealand tax system the Bureau's publication: TAXES AND INVESTMENT IN ASIA AND THE PACIFIC.

TAX REFORM

Following last year's Budget, I announced the establishment of a task force to examine the system of central government taxation, both direct and indirect, currently operating in New Zealand. In the time available, the Task Force on Tax Reform were not able to make firm recommendations on all aspects of taxation. Rather, they identified the areas of most immediate concern and suggested options for reform. These areas included personal income tax and indirect consumption taxes. In other areas they recommended further work.

As I said in last year's Budget, it is not possible to achieve overnight major changes in a tax system which has evolved over more than 100 years. Tax reform is a matter of identifying priorities and moving as circumstances and resources permit. The scope this year is limited by the overriding priority of reducing inflation. In this Budget, the Government is introducing major reforms in the area which it believes is of most widespread concern, namely personal income tax, and moving to eliminate some of the principal avenues for tax avoidance. Changes in the tax treatment of life assurance, superannuation, and building societies will also be announced. Other complex areas, such as the inflation adjustment of business income and the taxation of cooperatives, will require further study as the Task Force recommended.

PERSONAL INCOME TAX

In considering the options for changes to the income tax scale, the Government has placed major emphasis on five objectives. These are:

- first, to lessen substantially the fiscal drag in the present scale. Fiscal drag is the phenomenon by which, under a progressive tax scale and rising nominal incomes, tax paid rises faster than the growth in those incomes. Its effect is to erode disposable incomes and destabilise the economy;
- the second objective is to minimise the disincentive impact of high marginal tax rates on work, savings, and investment decisions;
- the third objective is to minimise the incentive for tax evasion and avoidance caused by high marginal tax rates;
- the fourth objective is to reduce the imbalance between the tax paid by single-income families and two-income families with the same total income;
- the fifth objective is to reduce the difference in tax burden between taxpayers with steady incomes and those with fluctuating incomes.

Clearly, the best way to achieve these objectives is to have a flatter tax scale, including a standard marginal rate covering the bulk of taxpayers and taxable income. At the same time, the Government wishes to reduce the average tax rate of most taxpayers, and to ensure that the degree of support provided to families with relatively low incomes is at least maintained. Naturally, compromises have had to be made. Nevertheless, I believe that the following decisions represent very substantial progress towards achieving all of these objectives.

The tax scale

From 1 October this year a new personal income tax scale will apply. Its main features will be:

- all taxable income up to $ 6,000 a year will be taxed at 20 cents in the dollar;
- taxable income between $ 6,000 and $ 24,000 a year will be taxed at the standard rate of 31 cents in the dollar;
- taxable income between $ 24,000 and $ 30,000 a year will be taxed at 41 cents in the dollar, and that between $ 30,000 and $ 38,000 a year at 51 cents in the dollar;
- the maximum tax rate of 60 cents in the dollar will apply to taxable income exceeding $ 38,000 a year.

One major benefit of the new tax scale is that, for approximately 90 percent of all taxpayers, the marginal tax rate will be 31 cents or less.

The 31 cent marginal tax rate itself will apply to over 60 percent of all taxpayers, a group which faces marginal tax rates ranging up to 60 cents under the present scale. The new scale will ensure that, as incomes rise, the vast bulk of taxpayers will not face higher marginal tax rates or sharply rising average tax rates as they do now. As a result, after-tax margins for skill and responsibility will be increased.

Family assistance

A major feature of personal income tax over the last 6 years has been the development of a system of rebates related to family circumstances and income. This approach is both taken further and simplified in the new system. In particular, the Government is continuing its policy of targeting family assistance rebates to those families with children where household income is relatively low. Accordingly, a family rebate of $ 1,404 a year will be introduced from 1 October to replace the present low-income family, young family, and spouse rebates. This new rebate will be available in full to all families with a dependent child and an annual household income of up to $ 9,800. It will then abate at the rate of 15 cents in the dollar over the household income range $ 9,800 to $ 19,160 a year. New tax codes to be introduced from 1 October will enable most eligible taxpayers to have the benefit of the family rebate in their pay packets.

Transitional measures

There will be some transitional problems with the introduction of the new tax scale, both at the lower and upper ends of the income range. At the lower end, some people who do not qualify for the family rebate would pay more tax as a result of the change in the scale. At the upper end, a small number of taxpayers would receive very large tax cuts. This latter effect is justified to a large extent, given that in recent years this higher tax rate thresholds have been less effectively adjusted for inflation than the lower thresholds. Nevertheless, to ease the transition to the new scale and to ensure that virtually all principal income earners receive a tax cut from 1 October this year, two transitional measures have been adopted:

- a rebate for principal income earners of 5.5% of taxable income, up to a maximum rebate of $ 312 a year, will be introduced. This rebate will be available to all taxpayers except children, spouses of principal income earners, national superannuitants, and principal income earners eligible for the new family rebate. Eligible taxpayers earning between $5,673 and $ 12,000 a year will receive the full $ 312 rebate. The rebate will abate against principal income at 12 cents in the dollar over the income range $ 12,000 to $ 14,600 a year;
- a temporary surtax of 10% of the marginal tax rates applying to all income above $ 24,000 a year will be levied.

The new income tax scale, rebates and surtax will be incorporated in the PAYE tables applying from 1 October this year. Because a totally new set of PAYE tax codes has been developed to accommodate the new rebate structure, most taxpayers will need to complete a new tax code declaration by 1 October.

The effect of the new income tax scale will also be incorporated in the calculation of the net national superannuation rates applicable from September 1982. Because national superannuation in calculated on an after-tax basis, national superannuitants will effectively gain the benefit of the new tax scale from that date.

The benefits of the new tax regime

To illustrate the effects of the tax changes on a full-year basis, a single taxpayer on $ 300 a week, which is about the average weekly earnings, will gain $ 10.34 a week, or $ 537 a year. This amounts to a cut in income tax of 11.4%.

For the single-income family on the same income, the gain will be $ 13.02 a week, or $ 677 per annum, where there is a child under 5. This is equivalent to a 15.8% tax cut. If the children are all over 5, the gain will amount to $ 17.76 a week, or $ 923 a year. This represents a tax cut of 20.3%.

Further examples of the effects of the tax changes for individuals at various income levels and in different family situations are set out in the Appendices to the Budget.

The estimated net full-year cost of this package of measures is $ 915 million. The cost in 1982–83 will be around $ 400 million.

Housekeeper rebate

One of the major advantages of the new income tax regime will be to reduce substantially the difference between the income tax payable by a single-income family and that paid by a two-income family on the same level of total income. On the other hand, to recognise the additional costs of child care incurred by two-income families, especially those with pre-school children, the present housekeeper rebate will be retained and increased. The rebate will also continue to apply to solo parents who are employed, and disabled spouses. From 1 October this year, the maximum rebate will be increased from $ 156 to $ 310 a year, at a rate of 31 cents in the dollar on qualifying expenditure up to a maximum of $ 1,000 a year. This rebate will not be incorporated in the PAYE tables and will be available only on an end-of-years basis.

Child rebate

In 1978 a special rebate of $ 78 was introduced to avoid the need for pre-school and school children to pay tax on small amounts of income. This rebate will be increased from $ 78 to $ 156 a year with effect from 1 October this year. At a marginal tax rate of 20 cents in the dollar, the new maximum rebate will be equivalent to tax-free earnings of $780 in a full year, compared with $ 538 at present. In the year in which a child leaves school and commences work, he or she may claim either the child rebate or the new principal income earner rebate, whichever provides the greater benefit.

Consequential changes

A number of changes and simplifications to the income tax system have been made possible by the introduction of the new income tax scale and rebate structure.

The overtime, shift work, and back-pays rebates were originally introduced to offset some of the effects of a steeply progressive tax scale. This reason no longer applies, and the rebates will be abolished from 1 October 1982.

The following rebates will be altered as from 1 October this year to reflect the new standard marginal tax rate of 31 cents for most taxpayers:

- first-home mortgage interest rebate: the maximum level of this rebate will remain at $ 1,000 a year, and the rate of rebate will be reduced from 50% to 31% of qualifying interest. This means that the maximum amount of qualifying interest will be raised from $ 2,000 to $ 3,225 in a full year;
- dependent relative rebate: the maximum level of this rebate will remain at $ 60 a year, and the rate of rebate will be 31% rather than 40%. The maximum amount of qualifying expenditure will rise from $ 150 to $ 194 a year. The number of dependent relatives in respect of whom a claim may be made will be limited to a maximum of two;
- charitable donations and school fees rebate: the maximum level of rebate will be increased to $ 200 a year, and the rate of rebate will be 31% rather than 50% of eligible donations and fees. The combined effects of these changes will be to raise the maximum amount of qualifying expenditure from $ 350 to $ 645 in a full year.

In order that the new family rebate can be administered effectively, it will be necessary for all salary and wage earners claiming it to furnish an annual tax return, even if their income is below $ 11,500. Their spouses will also be required to furnish returns if they derive income. This change will apply to returns in respect of the 1982–83 income year.

The rate of tax to be deducted by employers from secondary employment income and extra emoluments will be reduced from 35 cents to 31 cents as from 1 October 1982.

Home vendor mortgage rebate

Because of the small number of taxpayers who have claimed the home vendor mortgage rebate since its introduction in 1977, this rebate will be abolished. Only taxpayers holding approvals issued before tonight will continue to be able to claim the rebate.

TAX AVOIDANCE

The Task Force on Tax Reform highlighted the increasingly widespread avoidance and evasion of income tax. They believed that the reasons for this lay mainly in the high tax rates faced by many taxpayers and the availability of a variety of ways to divert income from taxed to untaxed sources. The Government accepts this view.

The new income tax scale announced tonight will reduce substantially the incentive to avoid and evade income tax. In addition, action is being taken on certain practices which are largely aimed at tax avoidance.

Leasing

The legislation regarding the tax treatment of lease payments in the hands of both the lessor and the lessee is to be amended. In respect of all financial leases entered into after tonight, the following tax provisions will apply:

- financial institutions will no longer be able to treat financial leases in the same manner as short-term hire contracts for income tax purposes. Instead, they will be required to follow generally accepted accounting practice and record their leasing transactions on the same basis as if they were loans;
- the lessor will be excluded from claiming depreciation allowances on assets subject to financial leases;
- the lessee will be permitted to deduct an amount equivalent to tax depreciation allowances for the particular leased asset, including first-year depreciation allowances if applicable, together with an amount equal to the interest content of lease payments.

These measures will place financial leasing on the same footing for tax purposes as other forms of financing the acquisition of assets, and will remove a significant avenue for tax avoidance. The existing tax treatment of leases of land and buildings and short-term hire contracts will not be changed.

Tax-free dividends

As from 1 April 1982 distributions of capital profits will qualify as tax free in shareholders' hands only when those profits have been realised outside any particular group of companies by way of armslength transactions. The aim of this measure is to prevent revenue losses arising from artificial arrangements to establish capital profits but which do not generate the cash to fund the resulting tax-free distributions to shareholders.

Farming and property investment

Under the existing income tax legislation, it is possible to deduct certain types of expenditure which are essentially of a capital nature. In the case of enterprises involving substantial interests in land, one of the few assets whose value is at least maintained in real terms, these provisions provide major avenues for tax avoidance. The concessions under which farming and fish farming development expenditure may be deducted, and livestock written down to standard or nil values, are the most obvious sources of this problem. Under inflationary conditions, however, it also has to be recognised that interest largely represents a repayment of capital. The fact that interest is deductible for income tax thus adds to both the incentives and the opportunities for avoiding income tax through the conversion of taxable income into non-taxable capital gain. Accordingly, a numer of measures are being taken to restrict these avenues for tax avoidance:

- under the present provisions, where a farm or fish farm is sold at a profit within 5 years of purchase and deductions have been allowed for development expenditure on the farm, that profit is treated as assessable income up to the extent of the deductions allowed. In order to deter the purchase and development of farms for capital gain rather than for productive use, the period of farm or fish farm ownership necessary to avoid recovery of the development expenditure deductions will be extended from 5 years to 10 years;
- interest deducted in respect of any land used in the production of income will become asssessable for income tax to the extent of profits made on the sale of that land within 10 years of its acquisition;
- new farmers and those purchasing additional land will be required to write down the value of livestock purchased from cost to standard or nil values progressively over a period of 3 years;
- losses created by the writing down of livestock to standard or nil values may in future be written off against farming income, but not against income from other sources;
- the period for determining basic livestock numbers under the nil standard value scheme will be extended from 2 to 4 years, or such shorter period as the Commissioner of Inland Revenue may determine;
- partnerships and syndicates of more than 6 persons engaged in farming, fish farming, horticultural and property owning ventures will be treated as companies for income tax purposes;

All of these measures will be implemented in respect of the income year beginning 1 April 1982, or equivalent accounting year. The provisions for the recovery of prior year expenditure will apply to property sold after tonight.

Film industry

The New Zealand film industry has grown rapidly in recent years. Part of this growth has been due to some tax shelter aspects arising from the use of so-called non-resource loans and other leveraging arrangements. In line with other moves to reduce tax avoidance practices, the Government is introducing a new tax regime which incorporates the main features of the tax treatment which applied to films in the past, but removes these tax shelter aspects.

The removal of the tax shelter will still leave the industry with substantial assistance from the Lottery Board, export incentives, and exemption from the film hire tax, which represents an appropriate level of support in the longer run. However, in line with its normal industry assistance approach of providing adequate time for adjustment, the Government has decided to give the Film Commission a grant of $ 1.75 million in 1982–83 in recognition of the effect that the change in tax treatment will have on the industry. This grant will be reduced progressively to zero over a period of 5 years.

Superannuation schemes for individuals

The last few years have seen rapid growth in the use of superannuation schemes for individuals to provide tax-free accumulation of income. Individuals are able to transfer large amounts of cash and capital assets, often the business assets of the contributor, to these schemes but at the same time maintain effective control of those assets. Such schemes are not superannuation schemes in the true sense.

I shall shortly be announcing changes in the taxation of all lumpsum superannuation schemes which will reduce these tax advantages, but additional measures are necessary. Accordingly, the rules under which superannuation schemes for individuals are approved will be tightened to stop their abuse.

In future, the Government Actuary will approve superannuation schemes for individuals under Part II of the Superannuation Schemes Act only if they meet at least one of the following criteria:

- they provide at last 75% of their benefits in pension form;
- the trustees and contributors are armslength parties.

Existing schemes which do not meet the new conditions will be given the option of converting to a pension scheme or winding up without additional tax liability. Alternatively, they may continue without the present tax advantages.

The necessary legislation will be introduced tonight.

Charitable companies

Some businesses carried on by charities enjoy an artificially advantageous position in the market through their exemption from income tax. Moreover, there has been a recent trend for individual business taxpayers to embark on schemes to secure the tax exemption for charities. A typical scheme involves the creation of a company, whose ostensible object is charitable, to conduct the business of a self-employed person. The company's net income, after payment of substantial remuneration to that person, is then tax exempt.

It is proposed to introduce legislation, which will be effective from 1 April 1983, to ensure that the business activities of charities will continue to be tax exempt only where the activity is directly related to the principal function of the charity concerned, or where the business employs that category of people for whose benefit the charity was originally established.

Personal tax

The legislation regarding personal tax concessions and rebates will be tightened with effect in the current income year:

- the Fourth Schedule to the Income Tax Act provides for the deduction of expenditure or losses incurred in the use of a private dwelling in connection with the employment of a taxpayer. Because of abuse of this provision, claims will be restricted to the additional expenditure incurred in the use of the specified room or defined area for purposes relating to the taxpayer's employment;
- the family rebate and the principal income earner rebate are designed to provide assistance to taxpayers whose annual income is below certain specified levels. Where a person enters or leaves New Zealand, the income derived during that part of the year he or she is resident in New Zealand is not an appropriate basis on which to calculate these rebates. Consequently, the income of a person in this situation will be grossed up to its full-year equivalent in order to determine the appropriate level of rebate. This will ensure that claims by such taxpayers are fully consistent with objectives of the rebates concerned.

Stamp duty

To prevent avoidance of stamp duty by transferring a property by way of a number of partial interests, the Stamp and Cheque Duties Act 1971 will be amended to ensure that such transfers are treated as one for the purposes of computing conveyance duty. This change will apply from tonight.

Administrative measures

The use of Inland Revenue code numbers in the tax system will be made compulsory. A tax intelligence unit has also been established to detect and police cases of tax avoidance and evasion.

The general tax avoidance provisions in section 99 of the Income Tax Act have not yet been tested before the courts, although some cases are in train. The Government will be watching the outcome very closely. If necessary, steps will be taken to give the legislation the force required to counter undesirable tax avoidance arrangements.

OTHER DIRECT TAX MEASURES

Bonus issue tax

The Task Force on Tax Reform concluded that the present bonus issue tax, while serving as an anti-avoidance measure, operates to inhibit the capital market. The Government broadly accepts the Task Force's view. Accordingly, bonus issue tax will be abolished.

To avert the potential tax avoidance problem identified by the Task Force, a new provision will be introduced. The objective will be to ensure that, when there is a return or reduction of capital within 10 years of a bonus issue being made from the capitalisation of revenue reserves, that part of the return or reduction which is applicable to the bonus issue will be taxable in the hands of the shareholder. Any reduction of capital will be deemed firstly to apply to such bonus issues made during the preceding 10 years.

The new legislation will apply to bonus issues made on or after 1 April this year. Any bonus issue tax paid in respect of bonus issues made subsequent to that date will be refunded.

Life assurance and superannuation

Following recommmendations of the Task Force on Tax Reform, the Government has reviewed the taxation of life assurance and superannuation.

The Government has decided that the overall tax relief given to these forms of long-term contractual saving and protection should continue. The balance is to be shifted, however, to reduce some of the present undue advantages of lump-sum superannuation, and to a lesser extent of life assurance, relative to pension arrangements. In addition, greater relief will be given at the point of initial saving or contribution rather than at the point where benefits are ultimately received.

As from the income year commencing 1 April 1982, the following specific changes are to be effective:

- life assurance companies will be taxed on net investment income at a rate of 31% instead of the present 30% of allotted bonuses and dividends;
- lump-sum superannuation funds, which are tax exempt at present, will also be taxed at 31% on net investment income;
- superannuation funds which provide at least 75% of benefits in pension form will remain tax exempt;
- the personal tax exemption limits for life assurance premiums and contributions to superannuation schemes will be increased from \$ 800 to \$ 1,200 for members of employer-subsidised superannuation schemes, and from \$ 1,000 to \$ 1,400 for persons who are not members of subsidised schemes.

Building societies

The Government has decided to implement the Task Force's proposal to tax the income of building societies at the company rate of 45%, commencing with the 1982–84 income year. Dividends paid on withdrawable shares will be deductible in arriving at a society's assessable income. Terminating group ballots will remain tax free in the hands of the recipient.

Investment allowances

A number of investment allowances for new plant and machinery are due to expire on 31 March 1983. Experience with these schemes indicates that they are not effective in achieving their original goals, and waste money in subsiding activities that are not the intended targets. Frequently their purpose has been fulfilled by broader policy moves or other events. Research, both in New Zealand and overseas, indicates that these incentives have had little impact on firms' investment decisions. Following a comprehensive review of investment allowance, the Government has decided not to extend the following schemes beyond their current expiry date of 31 March next year:

- the regional investment allowance;
- the export investment allowance;
- the fishing investment allowance.

The high priority activity investment allowance is to be terminated by allowing the high priority activity scheme, which was introduced with a specific lifespan of 5 years, to expire on 28 October this year. No applications for new approvals or extensions of high priority status will be accepted after tonight, but existing approvals will be allowed to run their course. The terminating date of the related investment allowance will be extended accordingly.

The terminating date of the industrial development plan investment allowance will be extended to 31 March 1986 in order to allow existing commitments to the wine and plastic industries and the New Zealand Steel expansion to be met.

As announced earlier, the farming and agricultural investment allowance is to be extended for a further year to 31 March 1984. This will allow time to consider its future in the context of overall assistance to farming in next year's Budget.

CNG and LPG conversions

At present, depreciation may be claimed for income tax purposes on the cost of CNG or LPG conversions carried out subsequent to the assembly of a motorcar purchased by a business. Depreciation on the cost of a conversion cannot, however, be claimed in respect of a car which has been converted during assembly and where the cost of the car itself is more than \$ 11,000. To correct this anomaly, the Income Tax Act will be amended to permit depreciation to be claimed on the cost of the assembly-line conversion of a business motor car to CNG or LPG. The depreciable cost for this purpose will be limited to the following:

- $ 1,200 for a one-cylinder CNG conversion;
- $ 1,600 for a two-cylinder CNG conversion;
- $ 1,400 for an LPG conversion.

This new provision will take effect from the income year which commenced on 1 April 1982.

Estate and stamp duties

In recognition of the effect of rising property prices:

- the exemption from estate duty will be increased to $ 350,000 in respect of the estates of people dying on or after 1 April 1983;
- the monetary limit in the definition of a "substantial interest" in a first farm will be increased from $ 100,000 to $ 150,000 as from tonight for the purposes of the stamp duty exemption.

The Minister in Charge of the Inland Revenue Department will, where necessary, announce further details of these tax measures.

INDIRECT TAXATION

Taxes on alcoholic beverages and tobacco products

The Government has reviewed the form and level of indirect taxes on alcoholic beverages and tobacco products. Because most of the taxes imposed in this area are levied at specific rates, regular updating is required to maintain both the real value of the revenue collected and the proportion of taxation in the price. It has been decided to increase the taxes on these goods by an average of over 30%.

Alcoholic beverages

The present ad valorem rates of sales tax on beer and spirits will be converted to specific rates. This measure has been undertaken at the request of the industry and so that the tax on each product can be more closely related to its alcoholic strength. One effect will be to alter the price relationships between higher- and lower-priced products.

Beer duty will be increased and amalgamated with the previous 30% sales tax on beer. As from midnight tonight, the rates of beer duty, which now incorporate sales tax, will be increased as follows:

- on beer with an alcoholic content of between 1.7 and 3 percent by volume, the rate of duty will be increased from 16 cent per litre to 21.5 cents per litre. On draught beer (in containers of not less than 8 litres capacity) the incorporation of the former sales tax will add 18 cents per litre to make the combined duty 39.5 cents per litre. On packaged beer the duty equivalent of sales tax will be 22 cents per litre, making a total beer duty of 43.5 cents per litre;
- on standard-strength beer (between 3 and 4.35% alcohol by volume), the rate of duty will rise from 20.5 cents per litre to 27.5 cents per litre. The incorporation of the former sales tax will bring the new combined rate of duty to 45.5 cents per litre on draught beer and 53.5 cents per litre on packaged beer;
- on beer with an alcoholic content of between 4.35 and 5% by volume, the rate of duty will increase from 31 cents per litre to 41.4 cents per litre, with sales tax adding a further 35 cents per litre to bring to combined beer duty rate to 76.5 cents per litre;
- on high-strength beer (in excess of 5% alcohol by volume), the rate of duty will increase from 41 cents per litre to 55 cents per litre. Adding in the former sales tax will bring the new beer duty to 99 cents per litre.

Corresponding adjustments will also be made to the customs duties on imported beer.

These changes will add 9 cents to the public bar price of a l-litre jug of standard-strength beer.

The existing sales tax of 50 cent per litre on table wines will be increased to 67 cents per litre. The tax on fortified wine will be increased from 60 cents to $ 1.06 per litre in order to bring the rate more closely into line with the taxes on other beverages on the basis of alcoholic strength. These changes will take effect from midnight tonight and will increase the price of a 750-ml bottle of table wine by around 13 cents and a similarly sized bottle of fortified wine by around 35 cents.

The domestic excise duty on spirits other than whisky will be increased from $ 9.07 to $ 12.10 per litre of alcohol, with commensurate increase in the customs duties on imported spirits. The excise duty on New Zealand whisky will remain at $ 8.77 per litre of alcohol. In addition, the present 40% ad valorem sales tax on spirits will be converted to three specific rates of sales tax as follows:

- on bitters and spirits containing not more than 23% alcohol by volume, the rate will be $ 2.15 per litre;
- on white spirits (gin, geneva, schnapps, and vodka), the rate will be $ 3.90 per litre;
- on all other spirits the rate will be $ 5.55 per litre

The new sales tax rate of $ 5.55 will raise substantially the tax on New Zealand whisky relative to that on higher-priced imported products. Because the rate of excise duty has not been raised, however, the net effect will be to preserve the competitive position of New Zealand whisky.

These changes to the taxation of spirits will take effect from midnight tonight and should add between 2 and 4 cents to the price of a nip in a public bar.

Tobacco products

The customs and excise duties on tobacco products will increase by 16% and the ad valorem sales tax will be raised from 25% to 40%, both with effect from midnight tonight. These changes will add approximately 20 cents to the price of 20 cigarettes and 35 cents to a 50-gramme packet of tobacco.

The 40% sales tax will also apply to cigarette papers (previously taxed at 20%) and to filter tips (previously exempt from sales tax).

The changes in the taxation of alcoholic beverages and tobacco products which I have announced tonight are expected to yield $ 115 million in a full year. While they will all take effect from midnight tonight, the operation of the Price Freeze Regulations will ensure that retail prices are not affected until existing stocks have been cleared.

The conversion of the present ad valorem sales taxes on alcoholic beverages to specific rates means that the industry will have to face up to regular adjustments of these taxes to ensure that their real value is at least maintained.

Petroleum fuels taxation

The Government has decided to adopt a more uniform taxation policy with respect to liquid fuels. This policy is designed to encourage greater efficiency in the use of imported fuels, and to encourage the development and use of indigenous substitutes.

In brief, the policy is that the relative prices of liquid fuels should reflect the relative costs of supply. Within this framework, taxes should not discriminate between fuels for similar uses. The taxes applying to oil products in the future will comprise three elements:

- first, an element of tax for the use of roads by those vehicles not levied under the road user charges system. This is made up of the existing sales tax on CNG and the National Roads Fund portion of motor spirits duty;
- secondly, an element of tax to encourage the development and use of indigenous alternatives to imported fuels. It has been decided to set this element, in the interim, at a specific rate equivalent to a 15% ad valorem tax at the wholesale level;
- thirdly, an element of general revenue or sales tax equivalent to a 5% ad valorem rate.

National roads fund contribution

To meet the light vehicles' share of the National Roads Board budget for the 1982–83 financial year, this element of motor spirits duty on petrol will be raised by 0.4 cents per litre to 6.4 cents per litre, and the sales tax on CNG will increase by 12 cents per gigajoule to $ 1.86 per gigajoule, both with effect from 1 October 1982.

From the same date, a sales tax at the equivalent rate of 4.93 cents per litre will be applied to LPG used in vehicles of 3.5 tonnes and under. This will replace the road user charges at present applied to such vehicles.

Consolidated account taxes

The existing specific Consolidated Account taxes and duties on petroleum fuels will be adjusted to the equivalent of a general 15% wholesale level tax. In addition, the specific equivalent of a 5% ad valorem wholesale sales tax will be levied on petrol. As from midnight tonight the new rates of Consolidated Account tax will be as follows:

- motor spirits duty on petrol will rise from 6.7 cents per litre to 9.8 cents per litre premium grade and 9.3 cents per litre on regular grade. This means that from 1 October 1982 the total duty on petrol, including the National Roads Fund contribution, will rise to 16.2 cents per litre on premium grade and 15.7 cents per litre for standard grade;
- aviation gasoline, currently taxed at 9.36 cents per litre, will be taxed at 11.2 cents per litre;
- the present 0.5. cents per liter sales tax on diesel fuel other than marine diesel will be increased to 7.2 cents per liter;
- the sales tax of 1.5 cents per litre on marine diesel will be raised to 5.8 cents per litre;
- home heating oil and kerosene, both at present subject to sales tax at 4 cents per litre, will be taxed at 8 cents per litre;
- the sales tax of 5 cents per litre on jet fuel will increase to 7.2 cents per litre;
- the rate of tax on fuel oils will rise from 1.5 cents per litre to 5 cents per litre.

Rebates

The present policy of rebating the National Roads Fund portion of motor spirits duty for off-road use of petrol or where vehicles are levied under the road user charges system will continue. Consolidated Account rebates will continue to apply to the currently approved categories but will be restricted to 2.5 cents per litre for both grades of petrol. This is the specific equivalent of the 5 percent general revenue tax.

As most use of other petroleum products is in commercial applications, which would qualify for rebates of a general revenue tax, it has been decided not to impose the additional 5 percent tax on these products. Similarly, the additional 5% tax is not levied on aviation gasoline and refunds of motor spirits duty on this fuel will be eliminated. The tax to encourage the development of indigenous fuel substitutes will not be eligible for rebates, since this would effectively negate the desired effect of the tax.

The changes to fuels taxation which I have announced tonight are estimated to raise $ 140 million in a full year. They represent a major step towards a comprehensive taxation and pricing policy that will provide a sound and economic basis for future energy development, and help lessen New Zealand's dependence on imported fuels.

International departure tax

The rates of international departure tax are to be increased from $ 35 to $ 40 for each adult and from $ 7 to $ 8 for each child under 12. These new rates will apply to al tickets supplied after midnight tonight.

Sales tax

A number of changes are to be made to the sales tax legislation to reduce the scope for avoidance and simplify administration.

Sale value

Legislation will be introduced tonight to amend the sale value provisions of the Sales Tax Act. The proposed reforms principally include:

- clarification of the provisions for determining the fair market value of taxable goods;
- clarification of the treatment of advertising, warranty, and other service charges;
- the inclusion of the freight and insurance costs incurred in bringing goods to New Zealand in the sale value of goods on which tax is paid on importation;
- the provision of an uplift of 15% of the sale value of goods sold directly by a manufacturer to a retailer. The intention of this uplift is to place such direct sales on a more equitable basis with sales made by traditional wholesalers.

These measures are aimed at combating a rising trend in tax avoidance and are intended to reduce variations in the impact on prices of an ad valorem sales tax on goods distributed by different methods. They are expected to raise an additional $ 60 million of revenue in a full year.

Farm motorcycles

The concession under which sales tax may be refunded on motorcycles for farm use is to be abolished from midnight tonight. Given that the use of farm motorcycles is now firmly established in the farming community, and in the light of continuing policing difficulties, this concession is no longer serving a useful purpose.

Administrative changes

The following changes are being made to streamline the administration of the present wholesale sales tax:

- refunds of sales tax will no longer be allowed on taxable goods used in the repair of exempt goods;
- the turnover limit for exemption of traders from licensing is to be increased from $ 1,000 to $ 5,000. The exemption for contractors will be increased from $ 500 to $ 2,500;
- provision will be made in the Sales Tax Act 1974 to license and tax Government agencies which perform manufacturing or wholesaling functions within the meaning of the Act;
- with effect from 1 January 1983, the present flat 10% penal tax on default of payment of sales tax will be replaced by a new penalty of 10%, increasing cumulatively by 2% each succesive month that the tax remains unpaid. The new penalty will operate on the day following the date on which the sales tax return is due and will also be applied to the collection of domestic air travel tax, international departure tax, and motor spirits duty.

With the exception of the new cumulative penalty provision, these measures will take effect from midnight tonight. Introduction of the new cumulative penalty provision will be delayed until 1 January 1983 to allow taxpayers in default, and those who normally pay after the expiry of the discount period, an transitional period in which either to wipe off their debts or to arrange finance for the faster payment of tax without penalty. The shortening of the period for payment without penalty will increase sales tax collections by about $ 45 million for this year only.

The Minister of Customs will announce details of these changes to indirect taxes later tonight.

PUBLIC ACCOUNTS

The Public Accounts for 1981–82 were tabled in the House recently. The main features of the Consolidated Account, the major operating account, were:

- ordinary payments, which comprise annual and permanent appropriations, totalled $ 10,899 million, an increase of $ 1,913 million or 21% over 1980–81;
- ordinary receipts, comprising taxation, interest, dividends, profits, and departmental receipts, totalled $ 9,843 million, an increase of $ 1,891 million or 24% over 1980–81.

After transferring $ 100 million from the Consolidated Account to the Reserve Account to cover the balance of the commitment due at 31 March 1982 in respect of supplementary minimum prices, a transfer of $ 1,281 million was made from the Loans Account to the Consolidated Account. This latter transfer was well within the $ 1,950 million allowed for this purpose in the 1981 Appropriation Acts.

CONCLUSION

Tonight's Budget has implemented the income tax reductions which I said would be the counterpart to the prices and incomes freeze. For most wage and salary earners, the reductions will be substantial.

Within the constraints imposed by the need to reduce inflation, the first stage of the Government's strategy for tax reform has been introduced tonight. The new income tax scale will substantially lessen both fiscal drag and the imbalance in the tax treatment of single- and two-income families. It will also reduce the incentive to evade and avoid income tax. The scope for tax avoidance has been further reduced by a range of specific measures.

These changes will be achieved within firm and consistent fiscal and monetary policies. The Government is determined that the freeze will work, and that inflation and inflationary expectations will be reduced substantially.

In the medium term, the Government will continue to pursue its goal of making the economy more flexible. A substantial reduction in inflation will greatly assist the realisation of the growth strategy, just as a more flexible economy will support the counter-inflationary measures.

The success of these policies will depend upon the support of the people. I am convinced that our people will respond to the challenge.

APPENDIX I
New income tax rate scale for individuals

	The rate of tax for every dollar is (%)
On so much of the taxable income as:	
Does not exceed $ 6,000	20.0
Exceeds $ 6,000 but does not exceed $ 24,000	31.0
Exceeds $ 24,000 but does not exceed $ 30,000	41.0
Exceeds $ 30,000 but does not exceed $ 38,000	51.0
Exceeds $ 38,000	60.0

A 10% temporary surtax on the marginal tax rates applying to taxable income in excess of $ 24,000 will also apply in conjunction with the above scale. The marginal tax rates that will then apply are:

	The rate of tax for every dollar is (%)
On so much of the taxable income as:	
Does not exceed $ 6,000	20.0
Exceeds $ 6,000 but does not exceed $ 24,000	31.0
Exceeds $ 24,000 but does not exceed $ 30,000	45.1
Exceeds $ 30,000 but does not exceed $ 38,000	56.1
Exceeds $ 38,000	66.0

Note: These rates will be reflected in new PAYE tax tables applying to pay periods ending on or after 1 October 1982, and become the annual rates in respect of income from 1 April 1983. The annual tax rate scale for the year ending 31 March 1983 will take into account the combined effect of the present and new scales on income earned during the year.

APPENDIX II
Examples of changes in tax paid

	Single taxpayer		Taxpayer with dependants*	
Weekly income	Weekly tax payable under new scale (including principal income earner rebate)	Change in tax	Weekly tax payable under new scale (including family rebate)	Change in tax
$	$	$	$	$
40	5.68	0	0	0
80	11.46	0	0	0
120	18.20	– 1.77	0	0
160	30.60	– 3.37	9.60	– 3.37
200	43.00	– 4.97	23.58	– 4.65
240	56.39	– 5.58	41.98	– 5.05
280	73.59	– 7.15	60.38	–10.22
320	86.20	–13.74	78.78	–15.82
360	98.60	–21.98	97.18	–20.40
400	111.00	–31.58	111.00	–28.58
480	138.26	–51.11	138.26	–48.11
560	174.34	–63.03	174.34	–60.03
640	217.25	–68.12	217.25	–65.12
800	313.76	–67.61	313.76	–64.61
1,000	445.76	–55.61	445.76	–52.61
1,200	577.76	–43.61	577.76	–40.61

* A taxpayer with dependants is a taxpayer who claims the spouse, young family, and low-income family rebates currently and who will be eligible for the new family rebate.

APPENDIX III(1)

Change in tax paid by a single person

Income		Present annual tax paid	New annual tax paid	Change in tax		Percentage tax change
Annual	Weekly			Annual	Weekly	
$	$	$	$	$	$	
10,400	200	2,494.3	2,235.9	– 258.4	– 4.97	–10.4
13,000	250	3,449.5	3,155.6	– 293.9	– 5.65	– 8.5
15,600	300	4,697.5	4,159.9	– 537.6	–10.34	–11.4
18,200	350	5,983.9	4,965.9	–1,018.0	–19.58	–17.0
20,800	400	7,413.9	5,771.9	–1,642.0	–31.58	–22.1
23,400	450	8,911.3	6,577.9	–2,333.4	–44.87	–26.2
30,000	577	12,871.3	9,462.5	–3,408.8	–65.55	–26.5
35,000	673	15,871.3	12,261.8	–3,609.5	–69.41	–22.7
40,000	769	18,871.3	15,259.7	–3,611.6	–69.45	–19.1

Change in tax paid by a single-income family with a child under 5(2)

Income		Present annual tax paid	New annual tax paid	Change in tax		Percentage tax change
Annual	Weekly			Annual	Weekly	
$	$	$	$	$	$	
10,400	200	1,468.1	1,226.1	– 242.0	– 4.65	–16.5
13,000	250	2,735.3	2,442.1	– 313.2	– 6.02	–11.5
15,600	300	4,295.3	3,618.1	– 677.2	–13.02	–15.8
18,200	350	5,827.9	4,814.1	–1,013.8	–19.50	–17.4
20,800	400	7,257.9	5,771.9	–1,486.0	–28.58	–20.5
23,400	450	8,755.3	6,577.9	–2,177.4	–41.87	–24.9
30,000	577	12,715.3	9,462.5	–3,252.8	–62.55	–25.6
35,000	673	15,715.3	12,261.8	–3,453.5	–66.41	–22.0
40,000	769	18,715.3	15,259.7	–3,455.6	–66.45	–18.5

Change in tax paid by a single-income family with a child over 5(3)

Income		Present annual tax paid	New annual tax paid	Change in tax		Percentage tax change
Annual	Weekly			Annual	Weekly	
$	$	$	$	$	$	
10,400	200	1,936.1	1,226.1	– 710.0	–13.65	–36.7
13,000	250	3,203.3	2,442.1	– 781.2	–15.02	–24.4
15,600	300	4,541.5	3,618.1	– 923.4	–17.76	–20.3
18,200	350	5,827.9	4,814.1	–1,013.8	–19.50	–17.4
20,800	400	7,257.9	5,771.9	–1,486.0	–28.58	–20.5
23,400	450	8,755.3	6,577.9	–2,177.4	–41.87	–24.9
30,000	577	12,715.3	9,462.5	–3,252.8	–62.55	–25.6
35,000	673	15,715.3	12,261.8	–3,453.5	–66.41	–22.0
40,000	769	18,715.3	15,259.7	–3,455.6	–66.45	–18.5

Notes:
(1) These taxables reflect the weekly tax changes on a full-year basis.
(2) These families may currently be eligible for the spouse, young family and low income family rebates.
(3) These families may currently be eligible for the spouse and low-income family rebates.

APPENDIX IV[1]

Change in tax paid by a married couple without dependants

Principal income earner's weekly income	Spouse's weekly income				
	$0[2]	$50	$100	$150	$200
$	$	$	$	$	$
200	− 1.97	− 2.27	+ 0.48	− 1.94	− 3.94
250	− 2.65	− 2.96	− 0.21	− 2.62	− 4.62
300	− 7.34	− 7.64	− 4.89	− 7.31	− 9.31
350	−16.58	−16.88	−14.13	−16.55	−18.55
400	−28.58	−28.88	−26.13	−28.55	−30.55
450	−41.87	−42.18	−39.43	−41.84	−43.84

Change in tax paid by a two-income family with a child under 5[3]

Principal income earner's weekly income	Spouse's weekly income				
	$0[2]	$50	$100	$150	$200
$	$	$	$	$	$
200	− 4.65	− 3.49	+ 4.91	+ 9.99	+11.06
250	− 6.02	− 0.71	+ 9.54	+10.19	+ 8.19
300	−13.02	− 5.98	− 0.16	− 2.57	− 4.57
350	−19.50	−16.88	−14.13	−16.55	−18.55
400	−28.58	−28.88	−26.13	−28.55	−30.55
450	−41.87	−42.18	−39.43	−41.84	−43.84

Change in tax paid by a two-income family with a child over 5[4]

Principal income earner's weekly income	Spouse's weekly income				
	$0[2]	$50	$100	$150	$200
$	$	$	$	$	$
200	−13.65	−12.49	− 4.09	+ 0.99	+ 2.06
250	−15.02	− 9.71	− 0.54	+ 1.19	− 0.81
300	−17.76	−10.71	− 4.89	− 7.31	− 9.31
350	−19.50	−16.88	−14.13	−16.55	−18.55
400	−28.58	−28.88	−26.13	−28.55	−30.55
450	−41.87	−42.18	−39.43	−41.84	−43.84

Notes:
(1) These taxables reflect the weekly tax changes on a full-year basis.
(2) These families are eligible for the present spouse rebate.
(3) These families may be eligible for the present young family and low-income family rebates.
(4) These families may be eligible for the present low-income family rebate.

Conference Diary

JANUARY 1983

British Branch of I.F.A.: Recent tax cases. London (United Kingdom), January 18 (English).

FEBRUARY 1983

British Branch of I.F.A.: Tax treatment of non-residents (Tax workshop). London (United Kingdom), February 8 (English).

Steuer-Telex-Seminar: Tax beneficial investment IX. Cologne, Frankfurt, Munich (Federal Republic of Germany), February 23-25 (German).

Management Centre Europe: International tax management (Seminar). Brussels (Belgium), February 28-March 1 (English).

MARCH 1983

British Branch of I.F.A.: Tax aspects of interest (Tax workshop). London (United Kingdom), March 2 (English).

Management Centre Europe: Managing and developing foreign subsidiaries (including: tax in international operations). Brussels (Belgium), March 28-30 (English).

APRIL 1983

The Taxation Institute of Australia: Sixth National Convention (including: the role of the High Court in interpreting tax statutes; taxation of technology; tax shelters and planning for the '80s). Melbourne (Australia), April 10-15 (English).

Management Centre Europe: International tax conference (including: intra-group services; relationships with the national Fisc in country of operation; changes in the tax climate). Brussels (Belgium), April 13-15 (English)

OCTOBER 1983

37th Annual Congress of I.F.A.: I. Tax avoidance/tax evasion. II. International problems in the field of turnover taxation. Venice (Italy), October 10-15 (English, French, German, Spanish).

FOR FURTHER INFORMATION PLEASE WRITE TO:

British Branch of I.F.A.: P.O. Box 68, Unilever House, Blackfriars, London EC4P 4BQ (United Kingdom).

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).

Steuer-Telex-Seminar: Dr. Peter Deubner Verlag GmbH, Abteilung Seminare, Postfach 410268, 5000 Köln 41 (Federal Republic of Germany).

The Taxation Institute of Australia: 113 Swanson Street, Melbourne VIC. 3000 (Australia).

BANGLADESH:

The Finance Ordinance, 1982

By K.A. Gofran*

Some important amendments have been made this year in the different fiscal statutes by the Finance Ordinance, 1982. This article summarizes a number of changes which are of particular interest.[1]

INCOME-TAX ACT, 1922

1. Exemption of income from property [Section 4(3)(xii)(ff)]

The income from newly constructed buildings having a plinth area of not more than 1,000 square feet was exempt from income tax for a period of 5 years from the date of completion, provided erection of the building was begun and completed at any time between 1 July 1980 and 30 June 1985 (both days inclusive). This restriction on the date of commencement of construction during the above period has been withdrawn with retrospective effect from 1 July 1980. The income of such a property is now eligible for exemption even if construction of the building commenced before July 1980 and was completed at any time between 1 July 1980 and 30 June 1985.

2. Exemption on account of conveyance [Section 7(1)]

Previously a salaried person enjoyed exemption for 4,200 Tk. if he owned and maintained at his own expense a car registered in his own name and did not receive any conveyance allowance or any other benefit or perquisite in lieu of such allowance from the employer. Similarly the exemption was for 2,400 Tk. if the conveyance was any other power-driven vehicle and 1,800 Tk. if he maintained no vehicle. The limits of the above exemptions have been raised to 6,000 Tk., 3,200 Tk. and 2,400 Tk. respectively.

3. Determination of notional income from self-occupied house [Section 9(2)(b)]

In order to simplify the calculation of the annual value of a self-occupied building of an assessee, an amendment has been made in clause (b) of sub-section (2) of Section 9. No tax is payable if the annual value of such property does not exceed 6,000 Tk. Under the previous wording, if it exceeded 6,000 Tk., a deduction of 6,000 Tk. was made and the balance so arrived at or a sum equal to 10% of the total income of the owner, whichever was less, was taken as the annual value. The position after amendment is that either the balance after deduction of 6,000 Tk or a sum equal to *10% of all other income excluding the notional income* from the residential house, whichever is less, is the annual value of the self-occupied house for the purpose of assessment.

4. Availability of accelerated depreciation [Section 10(2)(vi)(b)]

The date up to which accelerated depreciation was available in respect of any machinery or plant (other than office appliances and road transport vehicles) expired on 30 June 1982. The time limit has been extended to 30 June 1987.

5. Admissibility of festival bonus as business expenditure [Section 10(2)(x)]

A bonus paid to an employe is an admissible expenditure if it is a reasonable amount with reference to the pay of the employee, profit of the business and general practice in similar businesses. In other words, it is an admissible expenditure under certain conditions. These conditions have been waived in the case of admissibility of festival bonus as a business expenditure.

6. Exemption of capital gains invested in new industrial undertaking [Section 12B (7)]

Capital gains arising from the sale, exchange or transfer of lands or buildings have been made exempt from tax if they are invested for setting up a new industrial undertaking within the 2-year period immediately following the date on which the sale, exchange or transfer took place.

7. Furnishing of certificate by private limited company [Section 13A(1)]

Previously every private company whose paid-up capital on the last day of any previous year was 2,000,000 Tk. or more was required to furnish to the Deputy Commissioner of Taxes a copy of the balance sheet and profit and loss account duly certified by a chartered accountant. This limit of the paid-up capital has been reduced to 1,000,000 Tk.

8. Enhancement of exemption limit for investment by cottage industries [Section 14(3)(b)(ii)]

For the purpose of exemption of cottage industries the maximum investment limit has been raised from 10,000 Tk. to 50,000 Tk.

9. Withdrawal of earned income relief [Section 2(6AA) and (15A)]

The distinction between earned income and unearned income has been done away with this year by omitting the definition of "earned income" in Section 2(6AA). Consequently the earned income relief previously granted to an assessee other than a company has been withdrawn by omitting Section 15A. However, the National Board of Revenue has issued instructions to tax officials to allow the earned income allowance to salaried persons whose salary is liable to be charged to tax according to the rates as per the Finance Act, 1981 for the assessment year 1982-83 (see N.B.R. Circular No. 10 (I.T.) of 1982).

* Editor of *Bangladesh Tax Decisions.*

1. *Editor's note:* The November 1982 issue of the *Bulletin* contains extracts from the Budget Speech for 1982-83.

10. Withdrawal of restriction on investment allowance [Section 15(3A)]

The restriction imposed by the Finance Act, 1980 on the availability of the full benefit for investment in the purchase of Savings Certificates, etc. has been withdrawn. Henceforth the investment allowance will be available to an assessee for his full investment subject to the maximum of 30% of his total income or 35,000 Tk., whichever is less.

11. Exemption of contribution to Zakat Fund, etc. [Section 15DD]

A new Section 15DD has been inserted which provides an exemption in respect of any sums paid by an assessee as Zakat to the Zakat Fund or as a donation or contribution to a charitable fund established by or under the Zakat Fund Ordinance, 1982.

12. Withdrawal of exemption for educational expenses of children [Section 15E]

An assessee whose total income was not more than 50,000 Tk. previously enjoyed exemption of a portion of his income on account of the educational expenses of his children or children wholly dependent on him. This exemption has been withdrawn by omitting Section 15E. However, the National Board of Revenue has issued instructions to allow the exemption to salaried persons (if eligible) for the assessment year 1982-83 as in the case of the earned income allowance (see N.B.R. circular No. 10 (I.T.) of 1982 dated 31 July 1982).

13. Tax credit on investment of shares by a company [Section 15G(3)]

A company is entitled to a credit equal to 50% of the amount it invests in the purchase of shares or debentures issued by the Equity Participation Fund against the tax payable by it. Sub-section (3) of Section 15, which replaces the old sub-section (3), provides that where no tax is payable by a company in respect of the year in which the company makes such investment or where the amount of tax payable is less than the amount of credit, the amount of the credit or so much of it as has not been deducted, as the case may be, shall be carried forward and deducted from the tax payable by the company in the following year and so on.

14. Withdrawal of personal allowance [Section 15H]

Previously an assessee, whether an individual, Hindu undivided family, unregistered firm or association of persons, enjoyed exemption for 3,000 Tk. on account of personal allowance. This exemption has been withdrawn by omitting Section 15H. However, the National Board of Revenue has issued instructions to allow this allowance to a salaried person for the assessment year 1982-83 as in the case of earned income allowance (see N.B.R. Circular No. 10 (I.T.) of 1982 dated 31 July 1982).

15. Tax on non-residents [Section 17(1)(a)]

Provision has been made this year to charge income tax only at the maximum rate on the total income of a non-resident assessee other than a company. The other alternative – to charge tax at the rate applicable to a resident in such a case – has been abolished. The maximum rate of income tax has been fixed at 30% of the total income of a non-resident assessee according to the Finance Ordinance, 1982.

16. Reduction in the rates of tax on capital gains [Section 17(5)(b)(ii)]

The rates of tax on capital gains in the case of an assessee other than a company or a registered firm have been reduced and fixed as follows:

(i) Where the capital gains arise as a result of disposal by an assessee of his capital assets after 2 years but within 5 years from the date of their acquisition, the income tax is payable on the said gains at the rate applicable to total income including the said capital gains, or income tax at the rate of 25% on the amount of capital gains, whichever is lower.

(ii) Where the capital gains arise after 5 years but within 15 years from the date of acquisition of the capital assets, income tax payable on such gains is at the rate applicable to total income including the said capital gains, or income tax at the rate of 20% on the amount of capital gains, whichever is lower.

(iii) Where the capital gains arise after 15 years from the date of acquisition of the capital assets, the income tax payable on the capital gains is at the rate applicable to total income including the said capital gains, or income tax at 15% on the amount of capital gains, whichever is lower.

17. Withdrawal of exemption of capital gains [Proviso to Section 17(5)]

The provision of exemption of capital gains arising as a result of disposal of assets acquired before 14 August 1947 has been withdrawn by omitting the proviso to Section 17(5).

18. Enhancement of limit of income for liability to pay advance tax [Section 18A(1)]

The limit of total income for liability to payment of advance tax under Section 18A has been raised from 25,000 Tk. to 50,000 Tk.

19. Enhancement of the rate of interest on delayed refund of excess advance tax [Section 18A (5)]

The rate of interest for delayed refund of advance tax paid in excess under Section 18A has been raised from 10% to 13.5%.

20. Raising of limit of income for liability to furnish statement of assets and liabilities [Section 22(4A)]

Previously, an individual whose total income exceeded 25,000 Tk. was required to furnish along with the return a statement of assets and liabilities of himself, his wife or wives and his minor children. This limit of income has been raised to 50,000 Tk.

21. Abolition of provision for presumptive assessment [Section 23(3A)]

The provision of presumptive assessment introduced by the Finance Act, 1980 has been abolished by omitting sub-section (3A) of Section 23.

22. Requirement of obtaining clearance certificate for registration of documents [Section 47A(1)]

Clearance certificates previously had to be obtained from the Deputy Commissioner of Taxes in connection with the registration of any document purporting to transfer, assign, limit or extinguish the right, title or interest of any person in any property valued at more than 50,000 Tk. This limit has now been raised to 100,000 Tk. A clearance certificate is, therefore, not necessary for registering a document of a property valued at up to 100,000 Tk.

23. Taxable limit

The maximum taxable limit has been raised from 15,000 Tk. to 20,000 Tk.

24. Self-assessment

The scope of the scheme of self-assessment has been widened this year by raising the maximum limit from 25,000 Tk. to 50,000 Tk. Moreover, the salaried directors of limited companies have also been made eligible for self-assessment. The National Board of Revenue has issued Notification No. S.R.O. 276-L/82 dated 30 July 1982 in this regard.

25. Exemption of gratuity

Gratuity paid to a retired employee has now been totally exempted from the payment of tax (see N.B.R. Notification No. S.R.O. 226-L/82 dated 30 June 1982).

26. Exemption of royalty and technical know-how fees

Royalty and technical know-how fees have been exempted from payment of tax (see N.B.R. Notification No. S.R.O. 227-L/82 dated 30 June 1982).

27. The Sales-tax Act, 1951 (III of 1951)

The Sales-tax Act, 1951 (III of 1951) has been repealed and the sales tax law has been completely recast. A new Ordinance called the "Sales-tax Ordinance 1982" has been promulgated.

This Ordinance came into force on 1 July 1982. Sales tax will henceforth be levied at the import and export stages. Therefore, there will no longer be any sales tax on locally manufactured or produced goods. However, according to the provisions of the new Ordinance all pending sales tax assessments for the period up to 30 June 1982 will be made as before. The provisions of the Sales-tax Act, 1951, rules made and Notifications issued thereunder will remain in force for the purpose of pending sales tax assessments.

The administration of the Sales-tax Ordinance, 1982 will be the responsibility of the Customs Authorities.

28. The Urban Immovable Property Tax Act, 1957 (E.P. Act XI of 1957)

The rates of urban immovable property tax have been rationalised and reduced this year. The rates of this tax are as below after the amendment:

	Rates of tax
(a) in all cases of holdings within the limits of the Dacca Metropolitan Area the annual value of which does not exceed 18,000 Tk.	Nil
(b) in all cases of holdings other than holdings within the limits of the Dacca Metropolitan area the annual value of which does not exceed 12,000 Tk.	Nil
In other cases –	
(a) Not being self-occupied holdings	3% of the annual value
(b) Self-occupied holdings	1.5% of the annual value

In case the holding (not being a self-occupied holding) remains vacant for at least 60 days, the assessee is entitled to a remission to the extent of 3/4 of the amount of such period. The above rates are effective from 1 July 1982.

29. The Gift Tax Act, 1963 (XIV of 1963)

(a) *Exemption from gift tax* [Section 5(1)]

Gifts to father, mother, real sons and daughters up to 300,000 Tk. and to spouse up to 100,000 Tk. were previously exempt from tax. These two exemptions have been merged into one and the maximum limit of a tax-free gift has been fixed at 400,000 Tk. This means that gift tax is not payable on gifts made by an assessee to his real sons, daughters, father and mother or to his or her spouse for an amount up to a maximum of 400,000 Tk. in value in the aggregate in one or more previous years.

(b) *General exemption from gift tax* [Section 5(2)]

There was a general exemption from gift tax for an amount of 20,000 Tk. per year. This limit has been raised to 25,000 Tk.

(c) *Rates of gift tax*

Previously there were 6 slabs of rates of gift tax. The number of slabs has been reduced to 4 this year with a modification in the rates of tax in each slab. The rate of tax varies from 5% to 20% of the value of all taxable gifts.

30. The Wealth Tax Act, 1963 (XV of 1963)

(a) *Enhancement of exemption limit for self-occupied residential house* [Section 5(1)(xiii)]

The value of a house owned and occupied by an assessee for the purpose of his own residence was exempt up to 1,500,000 Tk. The exemption limit has been raised to 2,500,000 Tk.

(b) *Withdrawal of restriction on the aggregate amount of income tax and wealth tax*

Previously the aggregate of income tax and wealth tax could not exceed 60% of the total income of an assessee if his taxable income exceeded 150,000 Tk. This restrictive provision has been withdrawn.

UNITED STATES:

The International Banking Facility

by David A. Taran*

On 3 December 1981, U.S. Federal Reserve Board amendments authorizing U.S. depository institutions, Edge Act Corporations, Agreement Corporations and U.S. branches and agencies of foreign banks to establish international banking facilities in the United States became effective.[1] The amendments were necessary to permit banks within the United States to enjoy some of the competitive advantages available to offshore shell branches. Many states have already adopted enabling legislation and have favorably amended their state income tax laws.

Generally, an international banking facility, while based in the United States, enjoys the advantage of having its business activities treated as if conducted outside the United States.

An international banking facility is not a separately licensed bank or office of a bank, but, rather, a segregated portion, or division, of the business of such bank or office in the United States. This segregated portion is to be reflected in separate accounts segregated on the books and records of that bank or office, to be treated for regulatory and, generally, for state income tax purposes as being conducted outside of the United States.[2]

This article will first provide some vital background discussion on the international banking facility. Focus will then be directed to the state and local income tax relief afforded international banking facilities by the states of New York and California.[3] International banking facilities do not enjoy federal income tax relief.

1. BACKGROUND

International banking facilities may be maintained at any one or more of the U.S. agencies or branches of a foreign bank. Transfers of assets and liabilities between the international banking facility and the branch or agency of which it is a division or other domestic offices of the foreign bank would be subject to Eurocurrency reserve requirements as if the international banking facility were an offshore office of that bank.[4] Operations of the international banking facility can be conducted side by side with, and under the same management as, the domestic operations of the branch or agency, in the same manner as operations of offshore shell branches are conducted in tandem with domestic operations of U.S. banking offices.

International banking facilities are permitted to accept time deposits only from foreign offices of other U.S. depository institutions, or foreign banks, foreign residents, other international banking facilities and the foreign or domestic operations of the foreign bank in question.[5] This includes foreign affiliates of U.S. corporations, provided that funds received on deposit are not derived from the U.S. operations of the depositor and the size of such deposit is $ 100,000 or more.[6]

Time deposits may be held by the division in the form of deposits, borrowing, placements or equivalent instruments. To prevent purchase of such deposits by U.S. residents, no negotiable certificates of deposit, banker's acceptances, or other such negotiable instruments can be issued by an international banking facility.[7] Furthermore, international banking facilities do not have the authority to accept demand deposits.[8] Funds may be borrowed from foreign offices of other depository institutions, from other international banking facilities, and from foreign or domestic offices of the bank establishing the international banking facility.[9] Time deposits of qualified depository banks will not be subject to any minimum transaction amount. Any funds raised by an international banking facility, whether through deposits or borrowings, are exempt not only from federal reserve requirements but also from interest rate restrictions.[10]

On the loan side, international banking facilities can extend credit to foreign residents, other international banking facilities and, subject to Eurocurrency reserve requirements, to the U.S. offices of their parent banking institutions. However, loans made to a foreign resident cannot be repatriated to finance the U.S. operations of the borrower.[11] The effect of this is to permit the repatriation of Eurodollars, which can be held and exchanged in the United States through a network of international banking facilities. However, because of the limitations of lending and borrowing imposed on international banking facilities, Eurodollars held by international banking facilities cannot be integrated into the U.S. banking system, except through the "screen" of reserve requirements imposed on domestic borrowings of Eurodollars.

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* © 1982 David A. Taran. David A. Taran received his D.C.S. from McGill University, LL.L. from University of Ottawa, and J.D. from Columbia University. Mr. Taran is an attorney with the law firm of Graham & James in Los Angeles, and a member of the Editorial Advisory Board of the *International Tax Journal*. He is currently enrolled in the LL.M. (Taxation) program at New York University.

1. These amendments were made to Regulation D, 12 C.F.R. § 204.8 and Regulation Q, 12 C.F.R. 217.3(g).
2. See Regulation D. 12 C.F.R. § 204.8(a)(1).
3. As a result of the U.S. federal system of government, foreign banks are generally subject to U.S. income taxation on their U.S. operations at two levels, both the federal level and the state level. Federal income tax laws are normally of greater concern to a foreign bank operating in the United States. However, state income taxes can be substantial in amount and are not subject to the many tax treaties which the United States has negotiated with various foreign governments to mitigate the effect of double taxation.
4. See Regulation D, 12 C.F.R. § 204.8(a)(1).
5. See Regulation D, 12 C.F.R. § 204.8(a)(2).
6. See Regulation D, 12 C.F.R. § 204.8(a)(2).
7. See Regulation D, 12 C.F.R. § 204.8(a)(2).
8. See Regulation D, 12 C.F.R. § 204.8(a)(2).
9. See Regulation D, 12 C.F.R. § 204.8(a)(2).
10. See Regulation Q, 12 C.F.R. § 217.3(g).
11. See Regulation D, 12 C.F.R. § 204.8(a)(3).

2. STATE TAXATION

Since the purpose behind the international banking facility concept is to provide United States-based banking operations of foreign and domestic banks with many of the advantages of operating an offshore shell branch, a crucial element in this scheme is the availability of state and local tax relief. Many states have, therefore, enacted legislation granting an exemption, from state and local taxation, of the income of banking institutions which is derived from an international banking facility. This article will focus solely on the states of New York and California, both of which play a major role in international banking.

A. New York

Both New York and New York City enacted tax legislation on 19 June 1978, the effective date of which was deferred until 3 December 1981, which generally exempts net income derived by international banking facilities from state and local income tax by the mechanism of allowing the deduction of adjusted eligible net income (eligible gross income less attributable expenses, the ineligible funding amount, and the floor amount) from income subject to state and city tax.[12]

Gross income which is eligible for this relief includes income earned, by an international banking facility, from making, arranging for, placing, or servicing loans to foreign persons, making or placing deposits with foreign banks or foreign branches of banks (including foreign subsidiaries or foreign branches of the bank that has organized the international banking facility) or with other international banking facilities, and entering into foreign exchange trading or hedging transactions related to any of the above transactions.[13] In addition, where an international banking facility makes a loan to an individual who is a non-resident of the United States, to a foreign branch of a U.S. corporation, or to a foreign corporation or foreign partnership which is owned or controlled, directly or indirectly, 80% or more, by one or more nonbank U.S. corporations, U.S. partnerships or resident aliens, substantially all of the proceeds of the loan must be for use outside the United States if the gross income derived from that loan is to be eligible for the deduction.[14]

Although an international banking facility is limited to transacting business with foreign persons, the term foreign person has been given an expansive definition under the New York tax law. In determining whether an individual is a foreign person, citizenship is not the determining factor. Any individual who is not a resident of the United States should qualify as a foreign person, as should a foreign corporation, foreign partnership, or foreign trust, subject to the qualification that a U.S. branch of any of those entities will be a U.S. person.[15] Conversely, a foreign branch of a U.S. corporation, including the bank which organized the international banking facility, will constitute a foreign person.[16] An international banking facility, a foreign government, and international organization or any agency of either, will also qualify as foreign persons.[17]

Expenses and deductions attributable, directly or indirectly, to gross income which is eligible for the special international banking facility deduction must then be subtracted from eligible gross income to get a net income figure eligible for the special international banking facility deduction.[18] This net income figure is then subject to further downward adjustment where the international banking facility is partly or wholly funded from U.S. sources, as opposed to funded wholly from foreign sources.[19] This specific downward adjustment, by the ineligible funding amount, is computed separately each year and is equal to a fractional share – equal to the amount of liabilities of the international banking facility from domestic sources over the world-wide liability of the international banking facility – of the eligible net income.[20]

In addition to the downward adjustment to eligible net income for funding from U.S. sources (the ineligible funding amount), a further reduction of eligible net income by the floor amount may be required. Since the intent of the New York legislation is to grant the international banking facility tax benefit only to the extent that banks have increased their permissible activities in New York over the same activity conducted in New York during a base period, where a bank engaged in permissible activities during those base years, a downward adjustment is made based on the average of the annual aggregate amounts for the three base years, subject to a phase-out percentage based on a 10-year phase-out period.[21] This specific downward adjustment is computed separately each year and is equal to a fractional share – equal to the quotient of the product of the bank's loans and deposits during the base period, recorded in the financial books of its New York branch, agency, or office, which would have qualified as international banking facility qualified loans and deposits ("qualified loans and deposits") multiplied by the applicable phase-out percentage, all less the qualified loans and deposits for the current taxable year, other than those recorded in the financial books of the international banking facility divided by the qualified loans and deposits for the current taxable year, recorded in the financial books of the international banking facility – of the eligible net income less the ineligible funding amount.[22]

The base period selected for comparison, in determining this last downward adjustment to eligible net income, is 1975 through 1977. The phase-out percentage based on a 10-year phase-out period is:[23]

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12. See sections 1450(c), 1453(f), Tax Law; sections R46-37.0(c), -37.3(f), N.Y.C. Adm. Code. The effective date of these sections was deferred until 3 December 1981, the effective date of the Federal Reserve Board admendments to Regulations D and Q, see note 1.
13. See sections 1453(f)(2)(A), (B), (C).
14. See section 1453 (f)(8)(A).
15. See sections 1453(f)(8)(A), (B).
16. See section 1453(f)(8)(C).
17. See sections 1453(f)(8)(D),(E).
18. See section 1453(f)(3).
19 See sections 1453(f)(4), (5).
20. See sections 1453(f)(4), (5).
21. See sections 1453(f)(4), (6).
22. See section 1453(f)(6).
23. See section 1453(f)(6)(C).

Years	Phase-out percentage
1981 to 1985	100%
1986	80%
1987	60%
1988	40%
1989	20%
1990	nil

B. California

California tax law employs the unitary method of taxation based on world-wide combined reporting. Under the California unitary method of taxation, a three factor formula – based on real and tangible property, payroll, and sales –[24] is used in apportioning the income of a unitary[25] multi-state or multi-national business.

By comparing the size of a foreign bank's operations in California to the size of its world-wide operations, a fractional share – equal to the average of its California payroll over world-wide payroll, California sales over world-wide sales, and California property over world-wide property – is applied against its world-wide income to determine the amount of the bank's income subject to California state income tax.

The unitary method of taxation based on world-wide combined reporting can have an adverse effect on the taxation of foreign banks and, in general, has been vehemently opposed, because, it is claimed, it can inequitably and improperly allocate the tax burden of foreign banks and result in double taxation. Among some of the inequities and problems cited are the difficulties involved in the translation of foreign currency base financial statements into dollar base financial statements. Identical transactions, and loans by the foreign bank and its agency, branch, or domestic subsidiary or affiliate, will earn different amounts of income dependent on fluctuations in foreign currency exchange rates.

The unitary method of taxation, it is claimed, can be seen as a fee for doing business in California, and not an income tax. Since the amount of the tax imposed depends on a comparison of the size of the bank's operations in California to the size of its world-wide operations and not on the basis of its profitability in California, tax liability determined under the world-wide combined reporting method has taken on the appearance of a fee for engaging in business in California, a fee which is substantially out of proportion to the income earned in California.

The situation may be exacerbated by the existence of minority shareholders holding stock in a domestic bank which is combined with its foreign parent bank. Here the fair market value of the minority shareholder's stock will be decreased by the California tax liability.

While there have been continuing efforts to abandon the method of unitary taxation based on world-wide combined reporting, both in the California state legislature and the United States Congress, and continuing attacks on the constitutionality of the world-wide combined reporting method in the courts,[26] to date, all these efforts have failed. Limited relief, however, is available under the California tax law for international banking facilities. Legislation was passed by the California legislature and signed into law on 25 September 1981 which provides that, in determining the income of an international banking facility subject to California taxation, an international banking facility maintained by a bank in California shall be considered located without the state, and the property, payroll, and sales recognized as attributable to the international banking facility shall be attributed to the international banking facility in determining the property, payroll, and sales factors of the bank.[27] In effect, this will exempt income attributable to an international banking facility maintained in California from California taxation. The income attributable to an international banking facility will be determined in accordance with the usual California apportionment rules, including world-wide combined reporting for a unitary business; however, it may not be the same as the income shown on the books of the international banking facility as having been earned by the international banking facility.

3. FEDERAL INCOME TAXATION

The international banking facility is not a separately licensed bank or office, but simply a division of a bank, branch or agency. For federal income tax purposes, the international banking facility is taxed as a part of the bank, branch, or agency of which it is a division and not as a separate entity. It will be taxed under the normal federal income tax rules which, unless subject to a favorable treaty, will generally subject its income to taxation under the code rules regarding taxation of foreign and U.S.-source income effectively connected with a U.S. trade or business.[28]

Conclusion

The international banking facility is the newest of the banking vehicles available to a foreign bank operating or choosing to operate in the United States. It enjoys the advantage of having its business activities treated as if conducted outside the United States for both regulatory and state income tax purposes. However, because the international banking facility is not a separately licensed bank or office, but simply a division of a bank, branch, or agency, the international banking facility is taxed for federal income tax purposes as part of the bank, branch, or agency of which it is a division and not as a separate entity.

24. See sections 25101, 25121, Revenue and Taxation Code.
25. See Buthler Brothers v. McColgen, 17 Cal. 2d 664 (1941); Edison California Store v. McClogan, 30 Cal. 2d. 472 (1947).
26. The United States Supreme Court has granted certiorari to two cases dealing with the constitutionality of the state method of unitary income taxation based on world-wide reporting, and will continue hearing these cases in the next term. Chicago Bridge & Iron Co. v. Caterpillar Tractor et al., No. 81-349 and Container Corp. of America v. Franchise Tax Board, No. 81-523; see Chicago Bridge Unitary Case Deferred, Tax Notes, May 10, 1982, p. 513.
27. See sections 1, 2, 3 Ch. 825, 1981-1982, Regular Session, adding sections 23044, 25107, Revenue and Taxation Code.
28. See sections 894(b), (c), 881, 882, 894 IRC.

Fiscal Policies of the Middle East States with respect to Foreign Investment

Ahmed Abdullah Al-kadi *

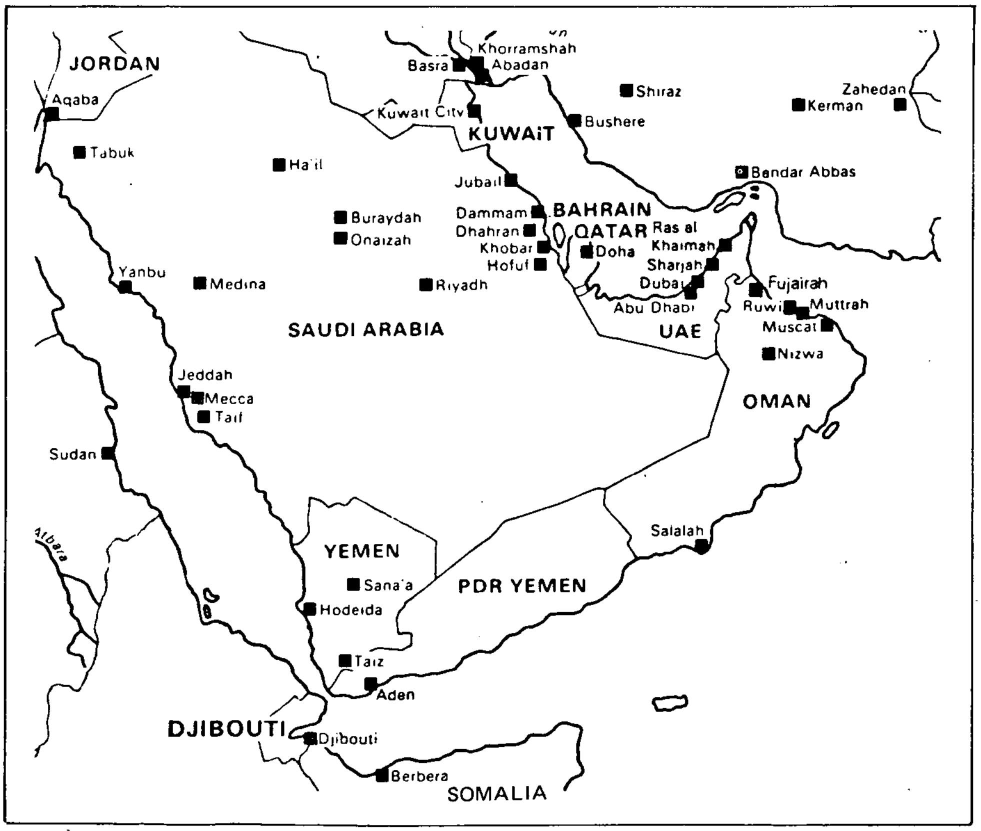
In trying to attract foreign investments, the Middle East States have created a good fiscal climate by enacting a number of investment laws which provide for numerous tax incentives and tax holidays. This article examines in particular the policies on inward investment of 3 States: the People's Democratic Republic of Yemen, the Yemen Arab Republic and Saudi Arabia.[1] The most favorable tax concessions are given to foreign investments in industrial and agricultural development schemes.

Examples are:

(1) The Law on the "Encouragement of Investment", No. 25 of 1981,[2] of the People's Democratic Repubic of Yemen provides for the following incentives: (a) exemption from customs duties on importation of machinery and construction materials necessary for the establishment or expansion of the project, on condition that such machinery and construction materials are not available in local production; (b) exemption from customs duties on the importation of spare parts for 2 years as of the date of the beginning of actual production for the market on condition that such spare parts are not available in the local market; (c) exemption or reduction of customs duties on importation of basic and raw material necessary for local production for 3 years as of the date of commencement of actual production for the market; (d) licensed projects are exempted from income tax for a period not exceeding 5 years as of the date of commencement of actual production for the market; (e) the project is allowed to carry over its losses according to Income Tax Ordinance 8 of 1961; (f) the investor and the participant are exempt from income tax on 30% of their profits derived from investing and participating in the project.[3]

(2) In the Yemen Arab Republic (North Yemen) under Law 18 of 1975, in connection with Promotion and Organization of Investment, a development project in which foreign capital may be invested is one which operates mainly in the fields of industry, agriculture, and tourism. Tax incentives are: (a) exemption from commercial, industrial and business taxes for 5 years as of the date of production. If the turnover of profits in the fifth year exceeds 2,000,000 Yemeni Rials, then for an additional 5 years tax will be charged at only half the normal rates; (b) exemption from the payment of all kinds of import and customs duties on equipment, spare parts, and building materials for 5 years, which may be extended for an additional 3 years.

(3) The most illustrative law is that of Saudi Arabia. The Foreign Capital Investment Code of 1964 (Royal Decree 35 of February 1964) provides



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1. Examples of policies of other States of the region, for the sake of comparison, are also indicated.
2. Law 25 of 1981 entered into force on 22 October 1981. It repealed the previous Law for Regulation and Promotion of Investment of 1969, No. 23 of 1971.
3. In addition to tax incentives, the Law provides for a number of financial facilities. For instance, projects with special importance to the domestic economy and whose products are not destined for export are allowed to transfer the entire amount of annual profits abroad. Foreign employees of the project are allowed to transfer abroad up to 75% of their income, after paying the income tax due.

for tax exemptions for licensed industrial and agricultural projects on net profits for 10 years, and 5 years for other projects.

Requirements for doing business

As a rule, participation of national capital in development projects is required. In the People's Democratic Republic of Yemen, under the above-mentioned investment law, the share of national capital, whether private or public, in an approved project is not defined. However, the Law establishes a Standing Committee which advises the Council of Ministers on almost all aspects of investment, including the proportion of foreign participation in an approved project. Under the Investment Law of the Yemen Arab Republic, there are three categories of enterprises: national, where the Yemeni capital is at least 90%; mixed, where the foreign capital is more than 10%; and finally foreign enterprises, where the foreign capital is at least 90%.[4] In Saudi Arabia, foreign capital may be invested without Saudi participation, but in this case it will not benefit from the provisions of the above-mentioned Foreign Investment Code. In Kuwait, under Section 26 of the Commercial Law of 1961, Kuwaiti participation in a joint business must not be less than 51%. The State of Qatar follows the example of Kuwait, except that non-Qataris wishing to invest in industry, agriculture, mining, and the tourism business may be exempted from the above rule by the Minister of Finance. In addition to this requirement, there are a number of other requirements which a foreign investor should fulfill before commencing business, including the license and registration requirements. In Democratic Yemen licenses are granted by a Standing Committee after the approval of the Council of Ministers.

When a license is granted, the enterprise is registered at the Civil Registrar. In the Yemen Arab Republic, the license is given by the Ministry of Economy. The project is registered in the Commercial Register within 30 days after granting the license. In Saudi Arabia, application must be made to the Foreign Capital Investment Bureau of the Ministry of Industry and Electricity to obtain a license to invest. Once the license is granted,[5] the project must be implemented within 6 months, otherwise the Minister may cancel it.[6] The project is registered in the Commercial Register at the Ministry of Commerce.[7] The date of granting the license is important for the foreign investor from the viewpoint of Saudi taxation. If the company signs a business contract before the license was granted to it, then it does not enjoy the tax holiday provided for in the Investment Code. In this case, the company is liable to Saudi income tax on all its income from the project including that part which accrued after the license was granted.

Forms of business and company taxation

Several forms of business where foreign capital may participate are known in the Middle East countries. In Democratic Yemen, no distinct legislation applies to corporate bodies, with the exception of State corporations. Private business is carried out by sole proprietorships, general and limited partnerships, and by private mixed or foreign companies. Private companies are taxed on the same basis as partnerships, at the rate of 37.5% of their annual net profits. The taxable income of a company is the gross income less deductible expenses which should be exclusively incurred by the taxpayer in the production of the chargeable income.[8] In the Yemen Arab Republic, the law regulating companies is Presidential Act 106 of 1976. Beside general and limited partnerships, joint stock and limited liability companies are known. The tax is levied on the net profits of a foreign company derived from industrial or commercial activities regularly carried on in the Republic. The annual taxable profits are charged at rates ranging from 7% on the first 7,500 Yemeni Rials (approximately 5 to 6 Rials equal US$ 1) rising to 25% on any profits in excess of 30,000 YR.[9] In Saudi Arabia, the most acceptable form of business for foreigners is the joint stock[10] or limited liability company. Companies are taxed on their net profits at rates ranging from 25% on the first 100,000 Saudi Rials, rising to 45% on any amount in excess of 1,000,000 SR[11] (parity for the Saudi Rial is maintained with the International Monetary Fund, so that 4.28 SR equal 1 Special Drawing Right – SDR). The Saudi tax system consists primarily of income tax and Zakat (an Islamic wealth tax on income and property). The Saudi portion of taxable income in a joint business is subject to the Zakat. Zakat rates are 2.5% on profits of a joint stock company, and 1.25% on profits of other legal entities. Zakat is levied on the total of the taxpayer's capital resources. Zakat and income taxes are collected by the Zakat and Income Tax Department. Generally, foreigners are subject to income tax,[12] while Saudis are subject to Zakat. Nationals of Kuwait, Bahrain and Qatar are con-

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4. Basically, non-residents may participate without limit in the capital of any kind of company incorporated in the Yemen Arab Republic.
5. A license is not required in connection with work done for the Government; the contract with the Government is enough. Licenses must be granted to those operating in the private sector.
6. When the project is incorporated, the corporation acquires Saudi nationality, and its headquarters should be in the Kingdom.
7. All persons carrying on business in Saudi Arabia must record certain information in the Commercial Register. An enterprise located in several Saudi provinces must register in each province.
8. The law regulating company taxation is Income Tax Ordinance 8 of 1961, which regulates taxes imposed on individuals. This Ordinance, enacted before independence, remains in its amended form the governing legislation for income tax purposes. State corporations, which are regulated by Law 13 of 1979, are also obliged to pay tax under the Income tax Ordinance (as amended).
9. The law regulating taxes on commercial and industrial profits is Law 11 of 1972. Individual taxpayers falling under this category of taxpayer have an exempt minimum amount of 7,500 YR.
10. Members of a joint stock company should number not less than 5, and are liable for company debts only to the extent of the value of their shares. The share capital of this form of company may not be less than 200,000 SR, but if such a company offers its shares to the public for subscription then the share capital may not be less than 1,000,000 SR.
11. Company tax rates apply to the following:
(a) net profits of a foreign company operating inside the Kingdom, or inside and outside the Kingdom simultaneously;
(b) the total share of the net profits of a Saudi company attributed to non-Saudi shareholders;
(c) the total share of the net profits of a partnership attributed to non-Saudi sleeping partners.
The tax is imposed on both companies on those non-Saudi individuals investing in a Saudi company (sleeping partners) at the company level rate.
12. An income tax law was introduced in 1950 (Royal Decree 17/2/28/3321). Since then it has undergone several amendments by Royal Decrees and Circulars. The income charged is the income derived within the Kingdom.

sidered Saudis for tax purposes. Joint stock and limited liability companies are also the most favorable forms of business for foreigners in the Gulf States.

In each of the United Arab Emirates,[13] different laws prevail with respect to the establishment of a business. In an attempt to harmonize these laws, particularly in establishing industrial projects, the Organization of Industrial Affairs Act (Federal Act 1 of 1979) was enacted which applies to all industrial projects in the Federation. The Act requires registration and licensing of all industrial projects by the Industrial Advisory Committee in the Ministry of Finance and Industry. Under Section 8 of the Act, no license will be granted to any project unless it is established by U.A.E. citizens or by a company 51% of which is owned by U.A.E. citizens. Foreign companies must comply with this requirement or wind up their business within 2 years as of the date of the Act. Projects meeting the requirements of the Act are granted several privileges, e.g. supply of land, electricity and water at nominal prices, an unlimited period of exemption from customs duties on import of machinery, equipment, raw materials, and an exemption of the profits from all taxes for a period of 5 years. Tax Decrees in the Emirates are almost the same. Taxes are generally very low. The first 1,000,000 Dirhams of taxable profits are practically not chargeable, 10% is charged on the next 1,000,000 Dirhams, rising to 50% on the amount in excess of 5,000,000 Dirhams. The Ruler has wide tax authority. He may exempt any enterprise, for any period of time, from taxes due and may even exempt any foreign project from the local participation requirement set by law.

Conclusion

Middle East countries fall under the category of developing states. However, unlike other developing countries, many possess huge monetary resources from which they are able to finance their development projects and schemes. For this reason, the interest of foreign businessmen and investors is more and more focused on this region.

The general attitude towards foreign investment is positive. Nevertheless, it is guided by two basic trends: the first is restrictive towards foreign individuals wishing to do business, particularly engaging in trade; the second is the waiving of restrictions and the offering of incentives for foreign investors desiring to do business in the form of companies where local capital is a partner. Therefore, it is more suitable for foreigners to invest their capital in joint stock and limited liability companies. In this case, the most preferential treatment is obtained by those foreigners who engage in projects defined by the local authorities as development projects. Such projects are in the first place industrial projects, promoting the production of local goods. Another notable trend now prevailing is that the governments of the Middle East countries are more and more engaged in mixed projects with foreign participation. Foreign partners in mixed governmental enterprises are exempt from fulfilling a series of requirements demanded by domestic laws, for instance, the license and registration requirements. The contract with the Government is enough to commence business, and in many cases will not render the foreign company liable to taxes.

13. The United Arab Emirates is a Federation of 7 Emirates, formerly known as the Trucial States. They are: Abu Dhabi, Ajman, Dubai, Fujairah, Ras al Khaimah, Sharjah and Umm al Quwain. Every Emirate has its own ruler. The President of the Federation is the Ruler of Abu Dhabi.

IFA NEWS

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USA BRANCH

The USA Branch of IFA will hold its annual meeting on 10–11 February 1983 in the Beverly Wilshire Hotel, Beverly Hills, California. The program features a number of "updates" during which speakers will discuss developments in specific fields. The subjects are:

Subject	*Speaker*
Technical update	D. Brockway
Treaty update	P. Lerner
Singapore update	D. Hong
Australia update	J. Kirkwood
Hong Kong and People's Republic of China update	P. Paul
Japan update	H. Olsen
FIRPTA	J. Forry

A panel consisting of Messrs. Hong, Kirkwood, Paul, Olsen, Tillinghast and Abrutyn will discuss Pacific Basin problems.

MALAYSIA:

The 1983 Budget

Extracts from the speech pronounced by the Minister of Finance, Y.B.M. Tengku Razaleigh Hamzah, introducing the Supply (1983) Bill in the House of Representatives on 22 October 1982.

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Sales tax

As a revenue measure, I propose to increase the rate of sales tax from 5% to 10%. This tax presently affects only about 25% of the goods imported and produced in the country. Thus, about 75% of all these goods are exempted and these include food items, pharmaceuticals, raw materials and machinery, construction equipment and building materials. I want to make it clear that these items will continue to be exempted.

Service tax

I also propose to increase the scope and rate of the service tax as follows:

(a) the current rate of 5% will be increased to 10%; and

(b) the service tax will now be extended to include all restaurants, bars and coffee houses located outside hotels and also private clubs. However, this change will only apply to these establishments if their annual sales turnover is $ 500,000 and above, and this will be made effective from 1st January, 1983.

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Export incentives

In order to strengthen the Balance of Payments I propose to improve certain export incentives. Currently, the export allowance and the double deduction on expenses for export promotion are only limited to manufacturers who export. These incentives will now be extended to traders who export locally manufactured goods. Further, it is proposed that:

(a) the present export allowance of 2% on ex-factory value of exports and 10% on the increase in value of exports, will be replaced by a new flat rate of 5%;

(b) the export allowance will now be calculated on the basis of f.o.b. value of exports; and

(c) the maximum allowable double deduction for overseas accommodation and subsistence expenses will be increased from the present $ 100/- per day to $ 200/- per day.

Liberalisation of exports

The Government will also liberalise the export of a number of products by removing the present export licensing and export duty of 5%. Thus, export licensing will no longer be required for the export of various products such as sugar confectionery, chocolate, mee-hoon, mee and similar products, fruit juices, aerated waters, PVC resin and compounds, glass bottles and wire ropes.

The export duty on cement and clinker, round and flat bars of iron and steel as well as mosaic, wall and roofing tiles will be abolished. However, since these items are classified as essential materials that are required by the housing and construction industry, they will continue to remain under export licensing.

In line with the proposals to liberalise exports, I also propose to abolish the 15% export duty on coconuts and copra. Coconut prices in the country have declined sharply in recent months and are much lower than the prices obtained in the export market. With the lifting of the export duty on coconuts and copra, this will help to facilitate export and improve the incomes of coconut producers and smallholders in the rural areas.

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Liberalisation of import procedures

Hon'ble Members will recall that one of the measures introduced last year concerned the liberalisation of import duty procedures on a wide range of raw materials. As a continuation of this effort to improve the system of duty exemptions, I propose to expand further on the list of raw materials which are eligible for consideration under this new procedure. The procedure will be simplified by integrating the reduced surtax into the import duty, to enable manufacturers to obtain the reduced surtax on the raw materials automatically, without having to apply for it.

The Reinvestment Allowance amounting to 25% of the expenditure on plant, machinery and industrial buildings was first introduced in the 1979 Budget and will end in the year of assessment 1983. This incentive is aimed at encouraging manufacturing industries to undertake expansion of their plants. As this incentive has been found to be attractive to the private sector, I propose to extend the Reinvestment Allowance up to the year of assessment 1986.

Hon'ble Members will recall that in last year's Budget Speech, I also extended the Accelerated Depreciation Allowance to assessment year 1986 and at the same time, made this incentive available to all industries.

Import duty on motor vehicles for private use

Hon'ble Members will agree that we import a large quantity of conspicuous consumption and luxury items, which do not contribute to the productive capacity of the economy. For instance, in 1981 the import value of motor vehicles for private use amounted to $ 800 million, an increase of 12% over that of 1980.

I therefore propose to increase the import duty on completely-built-up (CBU) passenger cars for private use and to introduce for the first time, an import duty on completely-knocked-down (CKD) motor vehicles.

Thus, the import duty on CBU passsenger cars for private use will be increased:

For cars valued less than $ 20,000, from 60% to 90%;
For every Ringgit of the next $ 5,000, 110%;
For every Ringgit of the next $ 5,000, 135%;
For every Ringgit of the next $ 5,000, 160%; and
For every Ringgit of the balance, 200%.

For CKD passenger cars, I propose to introduce an import duty of 15%. This measure is designed to encourage a higher level of local content and import substitution in the motor vehicle industry. Commercial vehicles will not be affected by this new duty.

In addition, I propose that locally assembled passenger cars intended for use as taxis be given full exemption from excise duty.

Import and excise duties on liquor

From cars I move to liquor. I propose that the current import duty on beer and liquor be increased between a range of 10% to 40% and that the excise duty for locally produced beer and stout, be also increased by 60% from $ 1.25 per litre to $ 2.00 per litre.

Import and excise duties on tobacco

Similarly, I propose to increase the import duty on unmanufactured tobacco by 54% from $ 32.54 per kg. to $ 50 per kg. The import duty for cigarettes and other items will be raised within a range of 3% to 137%. Besides providing additional revenue to the Government for development purposes, these tax measures will also encourage the greater use of locally grown tobacco, and help increase the incomes of about 53,000 farm families. Consequent to the increase in import duty on tobacco, I also propose to increase the excise duty on locally manufactured cigarettes from $ 4.37 per kg. to $ 9.00 per kg.

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Computers

I would add that consistent with Government's wide ranging policies to encourage the private sector to modernise more rapidly and become more competitive internationally, I also propose to abolish the 25% import duty on computers.

Research and development

At present companies undertaking research are allowed single deductions for tax purposes in respect of expenditure incurred on research provided that the research is scientific in nature and is related to their business. It is now proposed to improve this incentive by removing these conditions so as to encourage more companies to undertake research. The improved incentives will be made available only if the companies undertake research that has been approved. The improved incentive is as follows:

(a) 1⅓ deduction for revenue expenditure for R and D;

(b) such research may be carried out by the taxpayer himself or on his behalf by any scientific association, university or college or research institution;
(c) buildings for R and D be deemed to be industrial buildings and be entitled for industrial building allowance.

As Hon'ble Members will agree, there is already a wide range of incentives for the private sector. These investment incentives are very liberal and include exemptions and allowances on income tax, import duties and sales tax. Further, the incentives cover not only the manufacturing sector but also other industries such as the hotel and shipping industries.

The main concern of the Government now is to allow time for these incentives to be fully absorbed into the economic system and to ensure that the various incentives are implemented effectively rather than offering new incentives. We want to be sure that the private sector is able to realise the full benefits of these extensive tax concessions and incentives before new incentives are provided. To this end, the Government will continue to improve the present system of incentives.

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Rubber smallholders

The rubber smallholders, rubber estates and tin producers have continued to be hit by both rising costs and lower income and profits at the same time.

I therefore propose to help alleviate the problems of our rubber and tin producers by taking the following actions:

(a) in the case of rubber, the export duty will now apply only when prices exceed 170 cents per kg. whereas before this, it was imposed when prices exceeded 154 cents per kg.;
(b) in the case of tin, the export duty will now apply only when prices exceed $ 26.40 per kg., whereas before this, it was imposed when prices exceeded $ 23.15 per kg.

Road tax

The Government has spent large sums of money to build new roads and bridges and to improve the existing network of roads. It is only fair that road users should pay more to assist in their maintenance. Furthermore, the rate structure should be made more progressive by injecting greater equity in the sharing of the burden in road taxes. I therefore propose to revise the road tax rates for cars for private use.

The proposal will not, however, affect owners of passenger cars with engine capacities of 1,200 cc. and below. Cars with engine capacities of more than 1,200 cc. will now be subject to higher road tax ranging from 20 cents per cc. to $ 3.60 per cc. for cars above 3,000 cc. Thus, owners of expensive cars, especially those in the 3,000 cc. category will pay more road tax. And owners of private diesel vehicles will pay five times more but at these new rates.

I must stress, however, that these revisions will not affect buses, taxis, hired cars and commercial vehicles.

Motor vehicles owned by companies

Company owned passenger cars however are in a different category. Since they are used for business purposes, they should be charged different rates. Consequently, I propose that the road tax on cars owned by companies, should be four times the road tax on cars for private use. However, taxis, hired cars and commercial vehicles owned by companies will not be affected by this proposal.

Appendices Concerning Taxation

APPENDIX I

Proposal to review the rate of sales tax

Presently, all essential items are exempted from sales tax. However all other items attract a sales tax of 5% except for a few luxury items which attract a sales tax of 10%. The 5% general rate of sales tax has been effective since 1972 when the sales tax was first introduced. There is therefore justification to raise this rate of tax to a higher level in order to increase the contribution of the sales tax to government revenue. It is proposed that the sales tax be increased to 10%. This increase will not affect essential items which will continue to be exempted from sales tax.

APPENDIX II

Proposal to introduce the "credit system" in the sales tax administration

Sales tax is a single stage tax which is imposed either at the importer's level or at the manufacturer's level. To avoid the multiple imposition of the sales tax, manufacturers are allowed to import or buy raw materials free from sales tax by using sales tax form No. 5. Some manufactures, however, are not able to utilise this facility to obtain tax exempt raw materials because of the size of their operations. They are therefore subject to sales tax on both the imports (raw materials) as well as the final products. To overcome this problem, it is proposed that the small manufacturers who for some reason or other are unable to utilise the facility under the present system be given "credit" for the sales tax paid by them on the purchase of the raw materials and this credit be utilised to offset the sales tax that is payable on their final products.
This proposal will take effect from 1st January, 1983.

APPENDIX III

Proposal to increase the rate of service tax

The current rate of service tax is 5% on taxable goods and services provided or sold in prescribed establishments. This rate of 5% was first imposed in March 1975 and has not been revised since then. It is proposed that the rate of service tax be increased from 5% to 10% in order to enhance the contribution of service tax to revenue.

APPENDIX IV

Service tax

Presently, the establishments covered by service tax are hotels, night-clubs, dance-halls, cabarets, health centres and massage parlours. The present coverage of the service tax is very narrow. It is therefore proposed that this base be widened and that the service tax be extended to the following:
(i) all restaurants, bars, snack-bars and coffee houses located outside hotels and having an annual sales turnover of $ 500,000 and above of prescribed goods and services;
(ii) all private clubs having an annual sales turnover of $ 500,000 and above of prescribed goods and services.
This proposal will take effect from 1st January 1983.

APPENDIX V

Proposal to abolish all duties from cine-cameras, sound recorders etc. for film of less than 16mm width, perfurmes, cosmetics, transistor radios and ball point pens (other than plastic)

In the last Budget all duties from cameras, watches, fountain pens and lighters were abolished with the aim of promoting tourism and the growth of related industries. It is now proposed that all duties on perfumes, certain types of cosmetics, cine-cameras, projectors, sound recorders, transistor radios and transistor radios with sound recorders and ball point pens (other than plastic) be abolished. These items are not produced locally and with the abolition of these duties it is envisaged that the retail trade in these items will further expand throughout the country. The full list of these items is in Attachment I.[1]

APPENDIX VI

Proposal to remove certain selected items from export licensing

To further encourage the export of certain selected products, it is necessary that these products be allowed to be exported freely. It is therefore proposed that the following products be no longer subject to export licensing:
(i) Sugar confectionery not containing cocoa
(ii) Chocolate, chocolate candies and other chocolate confectionery
(iii) Macaroni, spaghetti similar products like meehoon, kowy teow, mee and noodles
(iv) Fruit juices requiring dilution before use and packed for retail sale, including fruit cordials, fruit syrup, rose syrup etc.
(v) Aerated waters
(vi) PVC resin and compounds
(vii) Glass bottles
(viii) Rubber drying plant
(ix) Diamonds and precious stone set or unset
(x) Carbon black
(xi) Explosives
(xii) Wire ropes.

1. The Attachments are not reproduced here.

APPENDIX VII

Proposal to abolish the export duty on certain selected items

In order to encourage exports it is essential that they should be competitive in the world markets. Export duty is a factor which inhibits the penetration of these markets because it increases the price of the product exported. It is proposed that the export duty of 5% on the following items be abolished.

(a) Cement & clinker under Tariff Code		(b) Round bars of iron and steel under Tariff Code	
25.23	100	73.10	210
	200		290
	300		299
	900		
(c) Flat bars of iron and steel under Tariff Code		(d) Mosaic tiles under Tariff Code	
73.10	910	69.07	900
	930	69.08	900
	990		
(e) Roofing tiles under Tariff Code		(f) Frozen prawns under Tariff Code	
69.05	100	03.03	111 to 299
	900		

However to ensure adequate local supply, the export of these items wil continue to be subject to export licensing.

APPENDIX VIII

Proposal to abolish the export duty on copra and fresh coconuts

In the 1979 Budget the export duty on copra and fresh coconut was increased to 15% in order to discourage exports and ensure sufficient supply to domestic oil mills. This situation has however since changed. There has been a reduction of local demand for these products. The reduction in the demand for coconut and copra is due to an increase in the processing of palm oil and the production of edible oils from it on a larger scale. The depressed prices of coconut and copra have been further aggravated by the export duty and this has in turn affected the livelihood of coconut growers. In view of the above it is proposed that the export duty on fresh coconut and copra be abolished so that coconut growers will be able to get more competitive prices for their produce.

APPENDIX IX

Proposal to include raw materials in the Second Schedule of the Customs Duties Order, 1976

In the 1982 Budget the surtax on the imports of a wide range of raw materials which were not available locally was abolished. Instead, the reduced rate of surtax at 2% or 3% as the case may be, which was payable under the existing exemption was integrated into the import duty. The advantage of this proposal to manufacturers is that they can obtain the reduced duty of 2% or 3% for importing their raw materials without having to apply for it. As a continuation of this exercise additional items of raw materials have been identified and it is proposed that the surtax on these items likewise be integrated into the import duty structure. (A list of the raw materials is in Attachment II).

APPENDIX X

Reinvestment allowance

The reinvestment allowance amounting to 25% of the expenditure on plant, machinery and industrial buildings and first introduced in the 1979 Budget ends in the year of assessment 1983. This incentive is aimed at encouraging manufacturing industries to undertake expansion of their plants. This incentive has been found to be attractive to the private sector and is open to all industries which are not enjoying incentives under the Investment Incentives Act 1968. It is therefore proposed that the reinvestment allowance be extended up to the year of assessment 1986.

APPENDIX XI

Proposal to increase the import duty on passenger motor vehicles

In view of the large increase in imports of motor vehicles (CBU and CKD) it is proposed that as a revenue raising measure the import duty on the completely-built-up (CBU) motor vehicles be increased and that an import duty on completely-knocked-down (CKD) motor vehicles be imposed for the first time. This high duty will also encourage greater use of locally made parts. The new rates are as follows:

	Present rate	Proposed rate
(i) Import duty on CBU motor vehicles		
On value of less than $ 20,000	60%	90%
Next $ 5,000	70%	110%
Next $ 5,000	80%	135%
Next $ 5,000	90%	160%
On the balance	100%	200%
(ii) Import duty on CKD motor vehicles	Nil	15%

With a view to offset the increased cost of passenger cars to taxi operators due to the higher import duty, it is proposed that locally assembled cars intended for use as taxis be wholly exempted from excise duty.

APPENDIX XII

Proposal to increase the import duty and excise duty on liquor

The current rates of import duty and excise duty on liquor were imposed in 1980. From the health point of view, liquor is an item whose consumption should be discouraged. In view of this, it is proposed that the import duty on liquor be increased within a range of 10% to 40%. Further since some types of liquor are produced locally, it is proposed that the excise duty on beer and stout be accordingly increased by 60% from $ 1.25 per litre to $ 2.00 per litre. Details of the proposed changes are in the Attachment III.

APPENDIX XIII

Proposal to increase the import duty and excise duty on tobacco

Tobacco is another item whose consumption should be discouraged. The current rates of import duty and excise duty were imposed in 1980. In view of this, it is proposed that the import duty on unmanufactured tobacco be increased by 54% from $ 32.54 per kg. to $ 50 per kg. Similarly, it is proposed that the import duty on cigarettes and other items of manufactured tobacco be increased within a range of 3% to 137%. In keeping with the above increases it is proposed that the excise duty on locally manufactured cigarettes be increased by 105% from $ 4.37 per kg. to $ 9.00 per kg. Details of the proposed changes are in Attachment IV.

APPENDIX XIV

Revision of export incentive

In view of the strategy to stimulate exports of manufactured goods, the tax incentives for exports have to be reviewed in order to encourage the manufacturing industries to sustain and improve that export performance. It is therefore proposed that:

(a) the maximum allowable double deduction for overseas accommodation and subsistence expenses be increased from the present $ 100 to $ 200;

(b) the existing export allowance:
   - (i) be made available to all exporters, including traders;
   - (ii) the basis of calculating the allowance be based on f.o.b. value of export instead of the ex-factory value; and
   - (iii) the existing rate of 2% for value of export and 10% for increase in performance be replaced by a flat rate of 5%.

It is also proposed that Masterbatch be included in the list of products not eligible for export allowance.
This proposal will be effective from the basis year 1983.

APPENDIX XV

Proposal to abolish the import duty on computers

The current import duty on computers is 25%. It is felt that the private sector should be encouraged to make greater use of computers in order to increase its efficiency and performance. In view of this, it is proposed that the import duty on computers be abolished. However such imports will continue to be subjected to sales tax and surtax.

APPENDIX XVI

Promotion of local research and development (R&D)

At present companies undertaking research are allowed single deductions for tax purposes in respect of expenditure incurred on research provided that the research is scientific in nature and is related to their business. It is now proposed to improve these incentives by removing these conditions so as to encourage more companies to undertake research. These improved incentives will be made available only if the companies undertake research that has been approved. The improved incentives are as follows:

(a) 1⅓ deduction for revenue expenditure for R and D;
(b) such research may be carried out by the taxpayer himself or on his behalf by any scientific association, university or college or research institution;
(c) buildings for R and D be deemed to be industrial buildings and be entitled for industrial building allowance.

The proposal will be effective from the year of assessment 1984.

APPENDIX XVII

Proposal to review the present method of calculating the export duty of rubber based on the gazetted value of rubber

Since August 1981 the Government has been collecting export duty on rubber based on the gazetted value of RSS1, RSS3 and SMR20. Though this system is a simplification over the previous system whereby 9 different grades of rubber (3 RSS and 6 SMR) were used in determining the gazetted value of rubber, however it has been found that the present system is still not satisfactory in that it causes disputes on the grades of rubber to be exported especially those in the RSS1 and RSS2 categories because under the existing system though RSS2 is a lower grade of rubber as compared to RSS1 yet exports of RSS2 attract the same amount of duty as that of RSS1. This has resulted in much inconvenience and dissatisfaction amongst exporters. In view of this, it is proposed that the export duty on rubber be collected on the gazetted value of RSS2, RSS3 and SMR20 so as to minimise disputes pertaining to the grades of rubber that are exported and facilitate the clearance of shipments of rubber at the various points of export.

APPENDIX XVIII

Proposed changes to the threshold price of rubber and tin

The cost of production of rubber and tin has increased since the threshold price was last revised in December 1981. In view of the above, it is proposed that the threshold price of rubber be revised from 154 cents per kg. to 170 cents per kg. and that for tin be revised from $ 23.15 per kg. to $ 26.40 per kg.

APPENDIX XIX

Feedmill

Presently the import duty on wheat pollard and wheat bran attract an import duty of 13%. These are ingredients for the animal feed industry. As the present local supply of these products is insufficient to meet the needs of the feedmill industry, it is felt that a reduction in the import duty of these products will assist the feedmill industry and the poultry farmers in reducing cost of producing food. It is therefore proposed that the import duty on wheat pollard and wheat bran be reduced from 13% to 5%.

APPENDIX XX

Proposal to increase the road tax on private passenger cars

The road tax on motor vehicles for private use was last revised in 1980. In view of the current recession, it is proposed that the road tax be increased and that the existing road tax structure be made more progressive. The higher road tax will apply to both petrol and diesel powered cars.

The proposed road tax structure for petrol powered cars is as follows:

	Rate (cts. per cc.)		Road tax payable ($)		% increase in rate of road tax
Engine capacity	Present	Proposed	Present	Proposed	
First 1000 cc.	13	13	130	130	(Nil)
Next 200 cc.	15	15	160	160	(Nil)
Next 300 cc.	15	20	205	220 (60)	(33.3)
Next 500 cc.	30	35	335	395 (175)	(16.7)
Next 500 cc.	50	80	605	795 (400)	(60.7)
Next 500 cc.	80	200	1005	1,795 (1000)	(150.0)
On the balance	120	360	1605	3,595 (1800)	(200)

With regard to diesel powered cars, the road tax payable will remain at 5 times that of the road tax payable on petrol powered cars.

APPENDIX XXI

Proposal to increase the road tax on private passenger motor vehicles owned by companies

Presently there is no difference in the rate of road tax that is payable on a company owned car and that owned by an individual. As the maintance of cars owned by companies (inclusive of road tax) is treated as an expense item for purposes of income tax whereas no such allowance is given to cars owned by individuals, it is proposed that the road tax on motor vehicles owned by companies be payable at four times the road tax payable on motor vehicles owned by individuals.

APPENDIX XXII

Withholding tax on non-resident contractors and professionals

In order to resolve problems of taxing non-residents and at the same time to protect government's revenue, it is proposed that:
(i) All persons making payments to a non-resident person who is a contractor, consultant or professional shall upon paying or crediting such payments, deduct therefrom tax at the rate of 15% of the contract payment pertaining to the service portion of the contract.
(ii) All persons making payments to a non-resident person who is a contractor shall upon paying or crediting such payments, deduct therefrom a further 5% of the contract payment pertaining to the service portion of the contract to cover the tax obligation of the employees.

The taxes se deducted in (i) and (ii) above are to be accounted to the Revenue Department within 30 days of such payments. These deductions, however, are not a final tax. The final liability of tax will be computed when the taxpayer files in his income tax returns.

APPENDIX XXIII

Review of stamp duty

The last review made on stamp duties was in 1967. Therefore some of the duties are outdated and rates are low, having been eroded over the years by inflation.

Proposals

With a view to rationalising the existing rates and to deleting duties on instruments which are outdated, it is proposed that the First Schedule to the Stamp Duty Ordinance be reviewed:
(i) Duties which originally were at $ 1, $ 3 and $ 5 are recommended to be increased to $ 3, $ 5 and $ 10 respectively to suit current needs. Nevertheless, where appropriate, to lessen the tax burden on the lower income groups the current level of exemption for some instruments is increased or otherwise new exemption provisions are introduced e.g. for affidavits, although duty is increased from $ 2 to $ 5, an exemption provision is introduced for situations where the statutory declaration is required to conform with government regulations.
(ii) Duties on cheque to be increased from 10 cents to 15 cents and the existing $ 10/- duty each of article and memorandum of association for companies is to be increased to $ 100 each. The new rates do not apply to sole proprietorships and partnerships.
(iii) Duty on the transfer of shares, stocks or marketable securities which at present attract 2 separate duties of 15 cents ad valorem (i.e. where the name of transferee was filled prior to execution of transfer) and 30 cents ad valorem (i.e. for any other case) is recommended to be standardised to 30 cents ad valorem.
(iv) Duties imposed on instruments which are considered archaic such as charter party and notarial act are to be deleted.

APPENDIX XXIV

Tax exemption of pension and gratuity

With a view to retaining the benefits to the pensioners prior to the introduction of Cabinet Committee Report and to alleviate hardship for those who are retired due to ill-health it is proposed that:
(i) All gratuity received by Government employers, whose retirement is approved on or after the 22nd October 1982, be exempted from income tax.
(ii) Pensions received by persons retiring after reaching 55 or upon reaching any compulsory age of retirement under any written law, who are retired on grounds of ill-health also be exempted from tax. This proposal will take effect from year of assessment 1983.

APPENDIX XXV

Tax exemption for house owners on transfer

In the 1981 Budget, tax exemption on rental income from houses has been granted to persons who are being transferred beyond 20 miles of the original place of residence. This exemption however is limited to transfers within Malaysia. Persons on overseas transfers are not eligible.

With a view to giving equal treatment to such persons, it is proposed that this exemption be amended to include persons who are transferred overseas. The condition that such persons must first be in occupation of their houses before their transfers is retained.

SOLOMON ISLANDS:

New Income Tax Incentives for Investors

New incentives to encourage investment in Solomon Islands were introduced by the Minister of Finance, the Hon. B Ulufa'alu, in two orders signed on 6 August. The orders, which amend the Second Schedule to the Income Tax Act, are the Income Tax (Deduction of Capital Expenditure on Re-afforestation) Order 1982 and the Income Tax (Deduction of Capital Expenditure on Special Development Assets) Order 1982.

The purpose of the re-afforestation order is to encourage the timber industry to invest in re-afforestation by providing immediate tax relief for the cost of clearing and preparing land, purchasing, planting and maintaining trees and the costs of rents, rates, insurance and interest related to re-afforestation. Under the new law investors will be able to offset these costs against taxable profits in the year the re-afforestation expenses are incurred. There is also the option to spread the relief over 15 years.

The special development asset order provides a similar tax concession. The order permits the Minister in the national interest to declare the activity of any investor to be a special development activity for a period of up to 5 years. During this period the investor will be able to offset the cost of development activity assets against taxable profits in the year the asset is purchased or to spread the relief forward by claiming standard depreciation.

This concession is aimed at encouraging and promoting new forms of investment activity which will help to develop the Solomon Islands economy. Factors which the Minister will take into account in considering applications for special development activity status include the contribution the new investment activity will make towards increased exports, import substitution, employment opportunities and the development of rural areas.

A comprehensive description of the tax system of Solomon Islands is contained in our publication: *Taxes and Investment in Asia and the Pacific.*

SOME HIGHLIGHTS OF BUSINESS TAXATION

COMPANY TAX RATE – 35% for companies incorporated in Solomon Islands and 50% for other companies.

DIVIDEND WITHHOLDING TAX – Resident companies are required to deduct withholding tax from dividends at the rate of 35% from dividends paid to non-residents and at the rate of 20% in the case of dividends paid to residents. The gross dividends are a deductible expense of the paying company.

NON-RESIDENT WITHHOLDING TAX – Certain gross income payments to non-residents are liable to withholding tax in lieu of individual and company taxes. The rates of deduction are:

Interest	15 %
Know-how payments	15 %
Royalties	15 %
Income from contracting	6 %
Outward income from ships and aircraft	2.5%
Insurance premiums	15 %
Film rental	5 %

BONUS ISSUE TAX – Bonus issues are not subject to tax until the amount capitalised is distributed. The rate of tax on such a distribution is 20%.

BUSINESS LOSSES – A deficit for any year may be set off against the profits of a future year if the shareholders are substantially the same (51%). There are no time restrictions.

CAPITAL ALLOWANCES IN LIEU OF DEPRECIATION

Buildings, building fixtures and fittings, bridges, wharves, slipways, boilers and oil storage tanks	5% d.v.
Plant, machinery, ships, vehicles and aircraft	25% d.v.
Assets used by a timber concessionnaire for cutting, extracting and processing timber from a timber concession and low cost housing for employees	35% d.v.
Cost of purchasing and planting coconuts, oil palms and cocoa; provision of yards, fences and water supplies for livestock; prevention of soil erosion; experimentation, scientific or other research expenditure	100%
Capital expenditure on mining	20% p.a.

TAX HOLIDAYS – There is provision for the granting of tax holidays to pioneer companies where the investment is likely to provide significant benefits to the economy such as export contribution, net import substitution, increased employment and development of rural areas.

FOREIGN INVESTMENT – Foreign investment is governed by the Foreign Investment Act which can be obtained from the Government Printer, P.O. Box G. 14, Honiara.

PROVINCIAL TAXATION

Provinces have a wide range of rating powers including basic rates and rates on possessions and property. Basic rates vary between $1 and $90 a year and are generally at a uniform amount per capita, although some provinces 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 province's authority unless generally or specifically exempted. Only the Honiara Municipal Authority has introduced general property rates based on the unimproved value of rateable land in the town. The current property rate is 3.25%.

Business licence fees paid to provinces are treated as prepayments of income tax.

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